Joint Program of the Business Bankruptcy Committee, the Committee on Law and Accounting and the Women's Business Law Network
April 10, 2008
8:00 a.m. – 10:00 a.m.
Sharon Zemel Weiss, Program Chair

**PROGRAM: The 1, 2, 3's of Financial Statements**

The heart of any business is its finances. A good business lawyer must understand financial statements, whether her practice is transactional or litigation-based and whether she serves on a civic association or a board of directors. This lively program will start with the basics and go on to explain how the information contained in financial statements is used in the "real world".

Don't miss this opportunity to learn from our panel participants – representing the client, the lawyer, the academic, and the expert witness – as they reveal what all those columns really mean and why they should matter to you.

Chapter 11 Subcommittee Luncheon
April 10, 2008
12:30 p.m. – 2:30 p.m.
Susan M. Freeman, Chair; Timothy M. Lupinacci, Vice-Chair and Program Moderator

**PROGRAM: The Stalking Horse Whisperer: What Every Business Lawyer Needs to Know About Acquiring Distressed Companies Under 363 Sales**

In today's capital markets, investors increasingly look for opportunities to undertake strategic acquisitions of distressed companies for long-term profits. Sales under Section 363 of the Bankruptcy Code free and clear of liens, claims, and encumbrances are an effective tool for taking advantage of such opportunities. However, the business lawyer must be aware of the nuances and idiosyncrasies inherent in the Section 363 process when negotiating and implementing an asset purchase agreement in a bankruptcy case. The panelists will dissect the important terms and conditions of such an agreement in a Section 363 context, discussing, among other topics, bid procedures, break-up fees, post-closing purchase price true-ups, successor liability, and navigating through the bankruptcy process.

Secured Creditors Subcommittee Luncheon
April 10, 2008
12:30 p.m. – 2:30 p.m.
Corinne Ball, Chair and Moderator; Josefina Fernandez McEvoy, Vice-Chair

**PROGRAM: The Evolving Role of Market Valuation: Vlasic, Iridium, and Delphi, and Their Impact upon Market Makers and...**
Hedge Funds

The panel explores the impact of the leading Vlasic (a/k/a VFB, LLC), Iridium, and Delphi decisions as they affect issues such as the appointment of equity committees in chapter 11 cases, the evidence for ad hoc committees as to whether their members are "undersecured", and valuation disputes as they relate to plan confirmation, avoidance actions, and incentive compensation.

Joint Program of the Business Bankruptcy Committee and the Committee on Business and Corporate Litigation
April 10, 2008
2:30 p.m. – 4:30 p.m.
Eric Terry and Lisa P. Sumner, Program Co-Chairs; Corali Lopez-Castro, Moderator

PROGRAM: Daubert: Intruder or Invited Guest in Bankruptcy Cases?

Judges and lawyers share their first-hand experiences with application of the Daubert decision in bankruptcy court. Come and learn about: adaptation of the Daubert standards for bench trials; the bankruptcy perspective on what must be shown for a witness to be qualified as an "expert", and the most frequent types of expert battles in bankruptcy cases.

Joint Program of the Business Bankruptcy Committee, the Committee on LLCs, Partnerships and Unincorporated Entities, and the Committee on Middle Market and Small Business
April 11, 2008
8:00 a.m. – 10:00 a.m.
E. Paul Keiffer, Program Chair; David R. Weinstein, Moderator

PROGRAM: LLC or Not LLC – What Should Be the Question: Consequences of Entity Choice

Join this multi-disciplinary, scenario-based discussion of multiple business-formation circumstances – including start-ups, acquisitions, and mergers – as the panel addresses: (1) the level of fiduciary responsibility desired or required in the new or resulting entity; (2) tax and liability issues that often affect entity formation decisions, and (3) the practical and ethical problems that the chosen structure can pose if financial difficulty or bankruptcy ensues.

Business Bankruptcy Committee Forum
April 12, 2008
11:30 a.m. – 1:30 p.m.
Samuel R. Maizel, Forum Chair

FORUM TOPIC: Real Estate Lenders and Borrowers’ Bankruptcies – Sharks Gone Wild!

The Spring 2008 Forum looks at the ongoing upheavals in the real estate industry, with attention to both the commercial real estate and individual home markets. The Forum will begin with an overview of the economics of the real estate market, from both
the commercial and individual sides. Then, the panel will look at the unique issues arising in the bankruptcy cases of real estate lenders – in particular sub-prime lenders – and how those cases have played out in practice. Finally, we will discuss the fates of borrowers, both commercial and individual, and look at what, if anything, Congress is doing to remedy the current situation for home loan borrowers, as well as what the market is like for commercial loans.

**Subcommittee Meeting Programs at the 2008 Spring Section Meeting in Dallas, Texas**

**Insurance Subcommittee**
April 10, 2008
9:00 a.m. – 10:00 a.m.
*Robert M. Millner, Chair and Moderator*

"Chapter 11 Bolt-Ons"

The Spring subcommittee meeting will include a panel discussion of the confirmability, in asbestos-driven cases, of chapter 11 plans that feature "bolt-on" injunctions: that is, protections offered to non-debtor entities, such as former affiliates or asset purchasers or sellers, who pay for injunctions by contributing value to the plan.

**Executory Contracts Subcommittee**
April 10, 2008
11:00 a.m. – 12:00 Noon
*Thomas D. Goldberg, Chair and Moderator; Sharon Zemel Weiss, Vice-Chair*

"Hot and Emerging Topics"

Since BAPCPA became effective, issues relating to executory contracts continue to play a significant role in bankruptcy cases and seem to be constantly in flux. Join us for a lively discussion of the most current developments in this important area of bankruptcy law.

**JOINT MEETING:**
**Partnerships and Limited Liability Entities in Bankruptcy Subcommittee**
*Sandra A. Riemer, Chair and Program Co-Moderator; David F. Waguespack, Vice-Chair*

**Use and Disposition of Property Subcommittee**
*Steven Cousins, Chair; Sheryl E. Seigel, Vice-Chair and Program Co-Moderator*
April 11, 2008
9:30 a.m. – 10:30 a.m.

"It's a Question of Value: The Experts Talk about Valuing Your Assets"

Establishing appropriate valuations for assets can be crucial in bankruptcy and non-bankruptcy contexts. This program will focus on the many bankruptcy contexts in which valuations can be outcome determinative, including motions for adequate protection, approval of asset sales, relief from the automatic stay, the formation of equity committees, and plan confirmations.
Having a better understanding of the fundamentals of business valuation methodologies can assist legal advisors in strategic planning, critically evaluating and responding to expert reports and testimony, and presenting evidence at key hearings.

The program is designed for all business lawyers who may deal with valuation issues in their bankruptcy and non-bankruptcy practices and is open to all members of the Section of Business Law. It is designed to be an informative discussion with valuation experts, canvassing valuation concepts and issues, providing practical insights based on the experts’ broad range of experience, and encouraging the sharing of attendees’ questions, views and personal valuation experiences.

**Task Force on Current Developments**
April 11, 2008
2:30 p.m. – 4:00 p.m.
Martin J. Bienenstock, Chair and Moderator

"Current Developments in Bankruptcy Law"

The panel will discuss current developments and issues in various areas of bankruptcy law, with topics to include claims, exemptions, and priorities.

**JOINT MEETING:**
Bankruptcy Crimes, Fraud & Abuses of Bankruptcy Process Subcommittee
Gary E. Klausner, Chair; Regina Stango Kelbon, Vice-Chair and Moderator

Trusted/Examiners Subcommittee
David W. Allard, Chair; Brett D. Fallon, Vice-Chair
April 11, 2008
3:30 p.m. – 4:30 p.m.

"IS IT SAFE? – The Liability of Bankruptcy Trustees and Debtors in Possession"

This panel will focus on trustees' immunity, their liability and privileges, the Barton doctrine regarding suits against trustees, and the liability of debtors in possession for postpetition actions.

For more detail about the program and for materials about these topics, please click on the link below.

More Details...
Because most of us hold at least one state bar card and are admitted to practice in bankruptcy courts, we have a vague idea that there are multiple ethics rules that govern our ability to solicit committee representation. But we don’t spend a lot of time talking about the topic. That will change in Dallas in April.

Please join us for a roundtable discussion about committee solicitation and help us brainstorm about whether we need special ethics rules to govern such solicitations – and to protect us when we wear our state bar hats. Among our topics: What rules govern committee solicitations, and what rules should govern (that is, should we make uniform rules)? Should uniform rules override any state ethics rules that might also govern? Should the Office of the United States Trustee oversee solicitations? What should the remedies/sanctions be for wrongful solicitation? Who would have standing to complain of wrongful solicitation?

For an article related to these topics, please click on the link below.

Related Article...

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**Featured Article**

**Spotlight on... Claims Trading**

*Christopher Combest, Quarles & Brady LLP, Chicago, Illinois*

Selling a bankruptcy claim can be a smart way to receive a substantial payment and to bow out of a bankruptcy case much earlier than the selling creditor might otherwise be able to. However, these seductively simply transactions are laden with traps for the unwary business person, who may be taking on risks she didn’t anticipate and obligations she didn’t understand.

This article – Selling Bankruptcy Claims: Getting In on Cashing Out – examines the risks and opportunities for selling creditors and warns about what to look for before signing on the dotted line.

More...

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**Case Note**

**It's No Bull ? in El Toro Case, 9th Circuit Tightens Cap on Landlord Claims; Partially Overrules McSheridan**

*In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007)

In the February 2007 edition of this Newsletter, we reported on a Ninth Circuit Bankruptcy Appellate Panel case that held that 11 U.S.C. §502(b)(6) limits the amount of a landlord’s claim for lost rent under a rejected lease, but does not bar landlords from asserting damage claims for amounts other than lost rent. The BAP remedied that case for application of the Section 502(b)(6) standards contained in the BAP’s leading case on that issue, In re McSheridan.

Now, in El Toro, the Ninth Circuit Court of Appeals has gone further, specifically finding that clean-up costs imposed on a
landlord by a rejecting debtor-tenant are outside the Section 502(b)(6) cap and expressly overruling certain aspects of McSheridan.

For more information, see the attached case note by Christopher Combest, Quarles & Brady LLP, Chicago, Illinois.

More...
TRUSTEE IMMUNITY; TRUSTEE LIABILITY AND STANDARD OF CARE

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MUSINGS ON THE STANDARD OF CARE GOVERNING THE QUESTION OF TRUSTEE LIABILITY (PERSONAL VERSUS ESTATE); IMMUNITY

I. INTRODUCTION - THE BANKRUPTCY CODE AND RULES

Despite increasing attention given to the subject for several years, the United States Bankruptcy Code (the "Code") has not yet been amended to provide protection from personal liability for trustees and debtors in possession ("DIPs"). In an apparent attempt to compensate for the Code's deficiencies, many courts have strived to reach the right balance between protecting innocent trustees and providing effective sanctions for good administration.

What follows is a discussion of the various threads of analysis. Basically, we have the thing called the bankruptcy trustee, who is the administrator of the bankruptcy estate. Things can go wrong, and do go wrong. To what extent is the trustee personally responsible for things going wrong, and to whom is the trustee responsible? Because the trustee acts as the representative of the estate, when can the trustee assert that the conduct giving rise to the bad consequences arose out of the estate work, and therefore that the trustee is somehow protected because of her representational status and capacity? Because the trustee acts within a judicial system, and through proceedings overseen by the bankruptcy court, to what extent is the trustee protected because her actions are effectuated pursuant to court orders, directives, rules, etc.? Are there jurisprudential doctrines that recognize that the trustee is a creature of the bankruptcy process, and that the bankruptcy court, therefore, should be the first line of review as to the propriety of the trustee’s conduct? Just because the trustee is a creature of the bankruptcy process, can the trustee be insulated from liability when the trustee’s actions intersect with the non-bankruptcy world?

We will wind our way through these questions, doubtless without full success, but hopefully in a manner that will provide at least a jumping off point for further analysis by those affected.

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1 The authors of this paper include, as the two people who had the latest hand in things, Louis M. Phillips and Ashley S. Green. Earlier work was done by David W. Allard, for whom full credit is hereby given, acknowledged and appreciated.

2 See, *Mosser v. Darrow*, 341 U.S. 267, 274, 71 S. Ct. 680, 683 (1951) ("The most effective sanction for good administration is personal liability for the consequences of forbidden acts, and there are ways by which a trustee may effectively protect himself against personal liability" *Id.*).

3 As will be seen, there is a split in the circuit cases. Some hold that a trustee can be held personally liable for acts of negligence. See, In re Gorski, 766 F.2d 723, 727 (2d Cir.1985), and Baldrian v. Perry (In re Cochise College Park, Inc.), 703 F.2d 1339, 1357 (9th Cir.1983). Unfortunately, the negligence standard cases, discuss negligence based liability in the face of admitted protection through derived immunity. Clearly incompatible. Some hold that a trustee cannot be held personally liable for acts of negligence, but only for acts of gross negligence or willful misconduct. See, Sherr v. Winkler, 552 F.2d 1367 (10th Cir.1977); Yadkin Valley Bank and Trust Co. v. McGee, 819 F.2d 74 (4th Cir.1987); Ford Motor Credit Co. v. Weaver, 680 F.2d 451 (6th Cir.1982); United States, Etc. v. Sapp (In re Southern Foundation Corporation), 641 F.2d 182 (4th Cir.1981); In re Hutchinson, 5 F.3d 750 (4th Cir. 1993); In re Chicago Pacific Corp., 773 F.2d 909 (7th Cir. 1985); In re Smyth, 207 F.3d 758 (5th Cir. 2000).
The Code simply defines the role of a trustee by stating at Section 323(b): "The trustee in a case under this title has capacity to sue and be sued." Collier on Bankruptcy ("Collier") reports only that this provision is a logical adjunct to the duties to be performed by trustees (as listed in Sections 704, 1106, and 1302 of the Code) and refers to Rule 6009 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"). Bankruptcy Rule 6009 merely expands on the trustee's authority to defend any pending action or proceeding by or against the debtor, or to commence and prosecute any action or proceeding on behalf of the estate before any tribunal. Collier also provides the first reference researchers will find to personal liability of trustees as follows: "The trustee appears in his or her legal capacity and is entitled to Derived Judicial Immunity." As we shall see, this statement cannot be taken as a generalized statement of the extent to which trustees can expect to be protected by immunity doctrine. Though trustees have been recognized to be protected by derived immunity when acting pursuant to court order, we shall see that trustees should take great pains to recognize and understand the extent to which they are not protected by immunity.

As fiduciaries for all interested parties, bankruptcy trustees must often make difficult decisions which unavoidably disturb or dissatisfy one party or another. Therefore, it is not uncommon to find trustees being sued by secured creditors (who also routinely refuse to agree to section 506(c) surcharges for trustee services or expenses), by one or more unsecured creditors (who often disagree with the difficult decisions made by a trustee), and even third parties who are not officially "interested parties" in a case but who believe they may have been injured by a trustee's actions (or just as likely, by the bankruptcy process itself). Even more different are suits against trustees by debtors who are often engaged in openly hostile, adversary relationships with trustees. In re J.F.D. Enterprises, Inc. states:

As stated by the National Bankruptcy Review Commission:

There are a myriad of difficult decisions that may face a trustee trying to administer an estate:

In fact, trustees are commonly faced with decisions to either take action or not, whether it be to file a complaint, a motion to set aside a judgment, or to assume or reject a lease or other contract with virtually no notice. Sometimes trustees have only hours to make such decisions and are faced with the unenviable duty of preserving the status quo under the threat of rule 11 sanctions or being sued personally for failure to preserve and

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4 See, 8 Collier on Bankruptcy §6009.03 (15th Ed. 1993).

5 Id.


protect an intangible asset of the estate. Other decisions trustees face frequently include the decision whether or not to close a business in Chapter 11 or an operating Chapter 7, whether or not to attempt to sell assets or surrender them to secured creditors, whether to administer or abandon causes of action, and a myriad of other decisions which trustees must make upon conflicting, second-hand information being provided by the debtor and creditor groups, as well as professionals upon whom the trustee relies. Despite all this, trustees are expected to make such decisions in a timely manner. A trustee, unlike the debtor who often purchased the assets and created the problems which caused the filing, never holds a "full deck of cards to play."

Of course, one of the persons involved in this paper is a panel trustee, and has seen very bitter disputes, so readers might forgive up front any appearance of slant in favor of trustee protections.

II. OTHER FEDERAL STATUTES -

A. 28 U.S.C. §959(a)  A search for other federal statutes reveals that none squarely addresses the issue of immunity for trustees, or the standard of care imposed upon trustee action, and only one addresses the issue of suits against trustees. 28 U.S.C. §959(a) states as follows:

Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice, but this shall not deprive a litigant of his right to trial by jury (Emphasis added).

Case law makes it clear that this section actually provides a limited exception to the common law rule which holds that leave to sue trustees must first be obtained from the court appointing them. (The Barton Doctrine shall be discussed further in Section VI, below). The exception to obtaining leave arises only when a trustee is "carrying on business" connected with property of the estate.

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9 See, In re American Associated Systems, Inc., 373 F. Supp. 977 (E.D. Ky. 1974). See also, In re Burstein-Applebee Co., 32 B.R. 504 (Bankr. W.D. Mo. 1983); In re Campbell, 13 B.R. 974 (Bankr. D. Idaho 1981). Since the statute is completely predicated upon "carrying on business," which only DIPs, Chapter 11 trustees or the very few Chapter 7 trustees who are specifically authorized by court order can do, additional differences between trustees and DIPs may become apparent in the future.
B. 28 U.S.C. §959(b)

28 U.S.C. §959(b) states as follows:

Except as provided in section 1166 of title 11, a trustee, receiver of manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

In re Markos Gurnee Partnership, 182 B.R. 211, 227-28 (Bankr. N.D. Ill. 1995) discusses both personal liability and the trustee's obligation to abide by other laws. In this case, a Chapter 11 operating trustee failed to pay state sales taxes as required by law while operating a hotel and restaurant. The bankruptcy judge's decision on the merits was based on his finding that the taxes were incurred as a result of the trustee’s operation of the businesses pursuant to authority granted by the bankruptcy court. The bankruptcy court cited three principles of bankruptcy law as controlling. First, an estate is a distinct entity but not a legal person and can only be sued in the name of its trustee; the trustee is a party to such a suit in his official capacity only so the estate and not the trustee is liable. Second, the trustee is generally immune from suit for actions arising out of the operation of the estate; he is the legal representative of a separate entity, the estate. Third, the immunity is not unlimited; he can be held liable under two circumstances: when he operates ultra vires and when he breaches a fiduciary duty. The court noted that since the operation of the hotel had been authorized by the bankruptcy court his actions were not ultra vires. The state taxes arising from the operations became administrative expenses under section 503(b)(1)(B) of the Bankruptcy Code and owed by the estate only. The court also found that the claim for violation of fiduciary duty foundered because the state department of revenue had previously lost that fight when it unsuccessfully sought to have an equitable interest declared in the estate assets, which was not appealed. The district court affirmed in State of Ill., Dept. of Revenue v. Schechter. 195 B.R. 380 (N.D.Ill., 1996). The district court pointed out that "just as the trustee's conduct does not become ultra vires because it is negligent, so it does not become ultra vires because it violates an obligation imposed by state law". Id. at 224.

III. TRUSTEE IMMUNITY

Under prior law law, trustees and receivers acted as officers of the court and, as such, were seen as being entitled to judicial immunity. Boullion v. McClanahan, 639 F.2d 213, 214 (5th Cir.1981) (Trustee absolutely immune from suit for, inter alia, “(1) recommending an inexperienced appraiser; (2) allowing the filing of an incorrect appraisal; (3) improperly handling sales of the estate property...."); Kermit Construction Corp. v. Banco Credito Y Ahorro Ponceno, 547 F.2d 1 (1st Cir.1976); Bradford Audio Corp. v. Pious, 392 F.2d 67 (2d Cir.1968); Smallwood v. United States, 358 F.Supp. 398 (E.D.Mo.), aff'd, 486 F.2d 1407 (8th Cir.1973).

In Mosser v. Darrow, the trustee was held personally liable for willfully and deliberately
permitting his agents to profit at the expense of the estate.\textsuperscript{10} The Supreme Court offered two suggestions for avoiding personal liability:

1. Seek court approval with notice to creditors and other interested parties;

2. Account at prompt intervals, placing the burden on others to raise objections.

In \textit{Mullis v. U.S. Bankruptcy Court for Dist. of Nevada}, 828 F.2d 1385 (9th Cir. 1987), \textit{cert. denied}, 486 U.S. 1040 (1988), a debtor brought a civil rights action against bankruptcy judges, court clerks, and a trustee. The court found that the trustee had "absolute quasi-judicial immunity from damages," reasoning that the trustee derives his immunity from the judge who appointed him.\textsuperscript{11} Since judges had immunity, the Court concluded, "so did the trustee they appointed."\textsuperscript{12} In accord is \textit{Wickstrom v. Ebert}, 585 F. Supp. 924 (E.D. Wis. 1984), which, citing \textit{Smallwood}, states:

"[J]udicial immunity not only protects judges against suit for acts done within their jurisdiction, but also spreads outward to shield related public servants, including sheriffs, police officers, clerks of court, referees and \textbf{trustees in bankruptcy}, and receivers appointed to conserve assets."\textsuperscript{13}

Shortly thereafter, the United States Bankruptcy Appellate Panel of the Ninth Circuit issued an opinion which recognized the doctrine of derived judicial immunity in \textit{In re Jacksen}, 105 B.R. 542 (9th Cir. BAP 1989).

The Courts have recognized that "judicial immunity not only protects judges against suit from acts done within their jurisdiction, but also spreads outward to shield related public servants, including . . . \textbf{trustees in bankruptcy}" That immunity, however, is not unlimited.\textsuperscript{14}

The \textit{Jacksen} court then cited other appellate decisions which limited that immunity as follows: (i) "[A] bankruptcy trustee may be held liable for negligent as well as intentional conduct pertaining to duties placed on him by law."\textsuperscript{15} (ii) "[A] trustee has immunity only if his

\textsuperscript{10} 341 U.S. 267, 71 S. Ct. 680 (1951).

\textsuperscript{11} \textit{Id.} at 1390.

\textsuperscript{12} \textit{Id.} at 1391.

\textsuperscript{13} 585 F. Supp. at 934 (emphasis added).


\textsuperscript{15} \textit{Id.} at 544 (citing, \textit{In re Cochise College Park, Inc.} 703 F.2d 1339, 1357 (9th Cir. 1983).
actions are within the scope of authority conferred upon him by statute or the court."  

In *Boullion v. McClanahan*, 639 F.2d 213 (5th Cir.1981), the bankrupt debtor filed a breach of fiduciary action against the court-appointed trustee, alleging that he recommended an inexperienced appraiser, allowed the filing of an incorrect appraisal, improperly handled sales of the estate property, and failed to surrender disclaimed and exempt assets. The Fifth Circuit court found that all of the trustee's actions were approved by orders of the bankruptcy court and that the trustee was acting under the supervision and subject to the orders of the bankruptcy judge. The *Boullion* court held that since the trustee, "as an arm of the court, sought and obtained approval of his actions, he is entitled to derived immunity." 639 F.2d at 214.

Today, trustees are considered part of the executive branch and are overseen and appointed by the office of the United States trustee. The office of United States trustee was created by The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub.L. No. 99-554, 100 Stat. 3088 (1986). "The primary purpose behind the creation of the office of United States trustee [was] to remove the bankruptcy courts from the administration of bankruptcy cases." H.R.Rep. No. 95-595, at 113 (1977), reprinted* in 1978 U.S.C.C.A.N. 5963, 6074. In general, the United States trustee is charged with the duty to supervise the administration of cases and trustees in bankruptcy cases commenced under Chapters 7, 11, and 13 of the Bankruptcy Code. See 28 U.S.C. § 586(a)(3). The United States Trustee's office is now built into the Department of Justice within the Executive Branch, and ultimately with Congress and its oversight committees. 28 U.S.C. § 586(c). The judicial branch has no direct supervisory responsibilities or powers over the United States Trustee. Indeed, it was the express intention of Congress to remove the courts from the administration of the bankruptcy system (including supervision of its trustees). See H.Rep. No. 595, 95th Cong., 1st Sess. 107-115, U.S.Code Cong. & Admin.News 1987, 5787, 6068-6076 (1977). Congress specifically proposed that the United States trustees would carry out the bankruptcy laws in their duties relative to panels of private trustees. The United States trustee office is responsible for putting into effect the system of panels, and for carrying out the rules and regulations prescribed by the Attorney General governing qualification for panel membership.

The United States trustees will conduct investigations in appropriate circumstances to ensure that participants in bankruptcy cases are not avoiding the requirements of the bankruptcy code. ... In cases in which a private trustee serves, the United States trustee ... is permitted to conduct his own investigation into the existence of facts that should spur the private trustee to action. Such periodic examinations will be necessary for

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18 The United States trustee system was introduced by the Bankruptcy Reform Act of 1978 as an experimental pilot project to be implemented in eighteen judicial districts. Pub.L. No. 95-598, 92 Stat. 2549 (1978).
the United States trustee to exercise effective supervisions and make an
effective evaluation of the performance of the private trustees on the panel.

... The United States trustees will not be serving the bankruptcy courts as assistants or as arms of the court. The functions described above are not a part of the courts' duties in bankruptcy cases under the proposed law. The courts' duties relate solely to resolving disputes that arise in bankruptcy cases. Instead, the United States trustees' responsibilities will be to operate the bankruptcy system and to execute the bankruptcy laws. As such, the United States trustee is created in the Executive Department, as an Executive Branch officer, and is not placed in the Judicial Branch.


Although trustees are no longer considered an arm of the judicial branch, trustees should be immune for actions where the trustees have been directed to act pursuant to court order or delegation of judicial duties. The United States Supreme Court has outlined a functional approach to determine whether a person is entitled to immunity from suit.


In 1993 the Supreme Court outlined a two-step process to determine whether a court reporter was immune from suit, and thereby created a partial structure to be used in deciding whether immunity attaches to acts of others involved in the judicial process. Whereas courts prior to Antoine held that function alone was the determining factor, i.e., the “integral part of the judicial process” test. Antoine, however, held that “integral part of the judicial process” test was too broad. Immunity is extended to officials other than judges because their judgments are functionally comparable to those of judges. In other words, the immunity extends because the official exercises a discretionary judgment as a part of their function.

The Court first looked at the historical context – whether the relevant official at common law was historically immune from suit. The Court stated that court reporters were not historically afforded judicial immunity. However, this did not end the Court’s inquiry: “[W]hen judicial immunity is extended to officials other than judges, it is because their judgments are 'functionally comparable' to those of judges--that is, because they, too, 'exercise a discretionary judgment' as a part of their function.”

Curry v. Castillo (In re Castillo), 297 F.3d 940 (9th Cir. 2002)

A decade after Antoine was decided, the Ninth Circuit would use the two prong approach to determine whether a chapter 13 trustee was entitled to immunity. After filing bankruptcy under Chapter 13, the Debtor, Castillo, appeared for a § 341 meeting of creditors conducted by the Chapter 13 Trustee, Curry. Although Curry’s notes from the meeting indicated that the hearing would be continued to a later date, Curry’s office scheduled a hearing on confirmation of Castillo’s plan for a date prior to the date for which the § 341 meeting had apparently been
While the Trustee’s office scheduled the confirmation hearing, the Trustee and/or her staff failed to provide notice of the hearing date to Castillo or her attorney.

At the confirmation hearing, predictably, neither Castillo nor her attorney appeared. Because Castillo failed to appear and provide proof that she was making plan payments, the Court dismissed the case. About ten days after entry of the dismissal, the mortgagee on Castillo’s home foreclosed on the property and it was sold at a sheriff’s sale. Counsel for Castillo received notice of the dismissal three days after it was entered, however, took no action to vacate the dismissal until after the property had been sold at the foreclosure sale. Counsel for Castillo was ultimately successful in moving the Court to vacate the dismissal, however, the Court refused to set aside the sale of Castillo’s home.

Castillo responded by moving for leave from the bankruptcy court to sue Curry and a member of her staff who was apparently responsible for noticing confirmation hearings. Curry responded that she was entitled to immunity for their quasi-judicial actions. The bankruptcy court denied Curry’s defense and granted leave for Castillo to bring suit against Curry in state court.

The issue on appeal to the Ninth Circuit Bankruptcy Appellate Panel (“BAP”) was whether Curry was entitled to absolute immunity because her actions were judicial functions. Curry argued that she and her staff were immune from liability because in setting and providing notice of the confirmation hearing they were performing judicial functions. Curry also argued that she and her staff were entitled to qualified immunity because the actions complained of were undertaken in the administration of the bankruptcy estate. The BAP held that while the scheduling of the confirmation hearing was a judicial function entitled to absolute immunity, the failure to notice the hearing was an action to which Curry was not entitled to absolute immunity. Further, the BAP held that qualified immunity did not protect Curry for negligent performance of duties imposed on her by operation of law. The BAP, thus, reversed the bankruptcy court in part and affirmed the bankruptcy court in part.

In this case, the BAP concluded that the scheduling of hearings was a discretionary function which should be protected by immunity. Setting hearings involves management of the court’s calendar, which, the BAP noted, is a discretionary function normally performed by judges that furthers the ultimate process of adjudicating disputes between parties. Therefore, absolute immunity applied to Castillo’s claim against Curry for the allegedly wrongful scheduling of the hearing.

However, Curry was also required to send notice of the scheduled hearing, according to

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19 Apparently, the Chapter 13 Trustee had been delegated by the Court the authority to schedule the confirmation hearing and the duty to properly notice same.

20 Castillo filed a petition in state court which named, in addition to Curry, her bankruptcy attorney. Castillo’s bankruptcy attorney also moved for leave to bring a cross-claim against Curry. Again Curry advanced the defense of immunity and the Court again denied the defense and allowed the cross-claim to be brought.
Bankruptcy Rule 2002(b).  As the act of sending notice involved no discretion, the BAP held that the sending of notice of the hearing was a purely ministerial act for which no absolute immunity applied.

On the issue of qualified immunity, the BAP relied on In re Kashani, 190 B.R. 875 (Bankr. 9th Cir. 1995) for the proposition that:

As an officer of the court, the trustee is entitled to a form of derivative judicial immunity from liability for actions carried out within the scope of the trustee’s official duties. A trustee is entitled to such immunity only if the trustee is acting within the scope of the authority conferred upon the trustee by the appropriate statute(s) or the court. While a trustee is allowed to make reasonable mistakes where discretion is allowed, a trustee may be sued for intentional or negligent actions which amount to violations of the duties imposed upon the trustee by law.  

As the duty to give notice was delegated to Curry, Curry was not immune from suit for the alleged negligent noticing of the confirmation hearing.

In Castillo, the trustee, designated the power to schedule confirmation hearings, a discretionary control-of-the-docket power inherent in the function of courts to adjudicate the cases before them, derived judicial immunity for actions causing harm because she was acting under the designation of discretionary judicial power. The BAP’s treatment of the failure to notice issue, however, implies that such actions are not discretionary – they are mandated by the Bankruptcy Code. Absolute immunity, designed to protect the discretionary functions of the judicial power, does not apply when discretion is absent. Therefore, the trustee’s failure to notice was administrative and thus, the trustee was not entitled to assert absolute immunity for her actions, or non-actions, regarding notice of the confirmation hearing.

It is at this point that the BAP’s analysis went awry. The problem stems from the failure to distinguish between trustee liability for acts done in accordance with the duties of a trustee, i.e., administering estate assets, objecting to claims, etc., and those actions undertaken by a trustee which have been specifically delegated to the trustee by the court. In the latter situation, a trustee is not acting solely as a trustee, but rather as an officer of the court undertaking some judicial function delegated to him/her by the court. The threshold question to be asked is what action caused the damages of which the plaintiff complains. If the actions are solely related to the trustee’s duties as trustee, immunity, whether absolute or qualified does not apply. If, however, the actions allegedly causing damage are those undertaken as a result of judicial delegation of judicial power, then the trustee derives immunity from that delegation. In other words, if the judge who made the delegation would be entitled to immunity if, had he not

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21 Although Bankruptcy Rule 2002(b) requires the Clerk of Court to give notice, it allows the Court to designate otherwise. Curry had also apparently been delegated this function as well.

22 Kashani, 190 B.R. at 883 (citations omitted).
delegated the task, he performed the identical action as that performed by the trustee, then the
trustee who does perform that task subject to the delegation is entitled to the same immunity
applicable to the judge who made the delegation.

The subject of trustee liability, and the standard of care incident to imposition of that
liability, diverges into a different analysis once it is determined that a trustee acted pursuant to
some delegation of judicial authority. Analytically, the structure of trustee liability can be
thought of as two separate pipelines leading to the same point. If a trustee is not acting incident
to a delegation of judicial authority, then the analysis proceeds down the ordinary “trustee
liability” pipeline where the determination of standard of care is crucial. If, however, the trustee
is acting according to a delegation of judicial authority, then the analysis must proceed down an
“immunity” pipeline.

The BAP immediately recognized that the delegation, either implied or explicit, by the
bankruptcy court to the Chapter 13 trustee to schedule and notice hearings, required that the
analysis proceed according to that laid out in the “immunity” pipeline. Accordingly, the BAP
analyzed the applicability of absolute immunity and found that as to noticing hearings, absolute
immunity does not apply because noticing is not a discretionary function – it must be done. The
BAP, however, dropped the ball on the issue of qualified immunity. As the United States
Supreme Court has made clear, merely because an actor is not entitled to absolute immunity does
not necessarily mean that the same actor is not entitled to qualified immunity.23 After finding
that the Chapter 13 trustee was not entitled to absolute immunity, the BAP ostensibly delved into
the question of whether the Chapter 13 trustee was entitled to qualified immunity. However,
instead of analyzing the principles of qualified immunity, the BAP jumped back into the “trustee
liability” pipeline, proclaiming that trustees can be liable for negligence. The BAP court either
overlooks, or disregards, the fact that immunity prevents substantive application of the merits of
the case, i.e., “trustee liability.” As such, the analyses used in the “trustee liability” pipeline has
no application to an analysis under the “immunity” pipeline.

Instead, the BAP court should have looked to the principles of qualified immunity, as the
BAP had already implicitly determined that the Chapter 13 trustee was acting incident to judicial
delegation and immunity, whether absolute or qualified, was the appropriate “pipeline” from
which to determine the case.

Qualified immunity protects officials acting under the color of law from liability unless
their actions were a willful disregard of clearly established statutory or constitutional rights.24
Thus, to be entitled to qualified immunity, the actor must be a state or federal actor, i.e., an
official, acting under “color of law.” As has already been determined, the trustee was acting
pursuant to some form of judicial delegation, and therefore, may be properly said to be acting
under the color of law.25 Therefore, the question thus becomes, did the trustee act in willful or


reckless disregard of the plaintiff’s clearly established, pre-existing rights (and thereby caused the damage complained of). Nothing in the case indicated that the Chapter 13 trustee either intended to deprive the plaintiff of notice of the hearing, or that she recklessly disregarded plaintiff’s right to notice. Therefore, under a qualified immunity analysis, the Chapter 13 trustee would be entitled to dismissal on the basis of her qualified immunity defense. In this respect, the BAP was wrong.

On appeal, the Ninth Circuit affirmed in part and reversed in part. It agreed with the BAP that the scheduling of hearings by the bankruptcy trustee was a discretionary function protected by absolute immunity. However, when the BAP segregated the notice and hearing into two discreet tasks, it went astray.

The Ninth Circuit held that giving of notice was within the universe of quasi-judicial actions which should not be subject to collateral attack. It recognized the trustee’s arguments:

Curry asserts immunity from suit under the theory that bankruptcy trustees are entitled to quasi-judicial immunity for actions that are integrally related to the adjudication of the bankruptcy case .... Judicial immunity discourages collateral attacks on final judgments through civil suits, and thus promotes the use of "appellate procedures as the standard system for correcting judicial error.

Then, examining the historical functions of bankruptcy trustees, it concluded that current trustees’ functions included both adjudicatory and administrative functions. Historically, administrative functions were not subject to collateral attack.

The BAP went astray by segregating what is essentially one function -- controlling the docket -- into two discrete tasks. Both the scheduling and giving of notice of hearings are part of the judicial function of managing the bankruptcy court's docket in the resolution of disputes. This function is unquestionably discretionary in nature.

However, immunity is accorded to nondiscretionary acts if these acts are an integral part of a judicial function. Giving notice of the hearing, after the hearing has already been scheduled, cannot reasonably be separated from the act of scheduling and convening the hearing. A hearing without a notice, according to the court, is simply not a hearing. [A]ctivities, such as giving notice, that are: inexorably connected with ... and are analogous to judicial action invoke absolute immunity.... Thus, not only the actual decision ... but also activities that are part and parcel of the decision process justify absolute immunity.

The giving of notice is part of the process due litigants. Fundamental fairness to the parties before the court requires notice of proceedings. Notice is an essential part of this adjudicatory process. Therefore, we find immunity extends to the giving -- or failure to give -- notice, as well as to the scheduling of hearings. The judicial function at issue meets both prongs of Antoine. At common law the bankruptcy trustee would have enjoyed immunity
for the judicial function of controlling and managing her docket in
the bankruptcy proceedings, and both the scheduling and noticing
of the proceeding are a part of that discretionary function. See
Rodriguez, 116 F.3d at 66-67; Ashelman, 793 F.2d at 1078.

We do not hold that all of the Trustee's many functions are covered
by absolute quasi-judicial immunity. Cf. Lonneker Farms, 804
F.2d at 1097. We merely hold that the common law, legislative
history, and the grant of immunity to bankruptcy trustees and
similar judicial officers in analogous cases compel us to conclude
that Curry is entitled to quasi-judicial immunity for both
scheduling and noticing the confirmation hearing.

In re Castillo 297 F.3d at 952-53.


Chapter 7 trustee commenced an action against Debtors seeking denial of Debtors’
discharge pursuant to section 727. Debtors filed a counterclaim against Trustee and Trustee’s
attorney alleging (1) Removal of Trustee, (2) Wrongful Conversion, (3) Concealment of Assets,
(4) Refusal To Obey The Judge, (5) Abuse of Discretion, (6) Improper Administration, (7)
of Testimony, (11) Loss of Property, (12) False Representation, (13) Libel and Slander, and (14)
Damages. Trustee and Attorney moved to dismiss the counterclaim in its entirety.

The bankruptcy court held that, to the extent the claims sought damages on behalf of the
bankruptcy estate, Debtors had no standing to assert the claims. “Absent authorization by the
bankruptcy court, the Trustee is the only party who can assert a claim for damages on behalf of
the bankruptcy estate.” Id. at 685, citing In re Troutman Enterprises, Inc., 286 F.3d 359, 364-
365 (6th Cir.2002) (shareholder of debtor corporation for which trustee has been appointed does
not have standing to appeal bankruptcy court decision where only a derivative interest is asserted);
In re Perkins, 902 F.2d 1254, 1257-58 (7th Cir.1990) (creditor of chapter 7 estate does
not have standing to seek turnover of property alleged to belong to estate). “If a Trustee is the
cause of the damage, the appropriate remedy is to remove and replace the trustee. The successor
trustee may then bring the claim for damages against the removed trustee (and/or his surety
bond).” Id. at 686, citing 11 U.S.C. § 324(a); In re Ferrante, 51 F.3d 1473, 1478 (9th Cir.1995);
In re El San Juan Hotel Corp., 841 F.2d 6, 8-9 (1st Cir.1988). The bankruptcy court did
hold, however, that Debtors had standing to assert a claim for removal of Trustee, since Debtors
alleged that the estate was solvent. Also, to the extent that Debtors asserted a claim for libel and
slander, since the claims were personal to Debtors, it could not be dismissed on standing
grounds.

With respect to the claim of removal, Debtors did not need leave of Court. However,
with respect to the claim for libel and slander, the court held that a bankruptcy trustee could not
be sued without leave of the appointing court for actions taken in the scope of his or her
authority. Id. at 686, citing In re Bay Area Material Handling, Inc., 1995 WL 747954,
Moreover, this protection extends to other persons appointed by the court, including the trustee's counsel. *Id.*, citing *Bay Area* at *3; *DeLorean*, 991 F.2d at 1241. Since Debtors contended that Trustee and his attorney performed the duties (or failed to perform them) negligently or based on an improper bias against them, none of the exceptions for dispensing with the leave of court requirement applied.

Trustee also contended that dismissal was proper for another reason: that he was immune from suit on the claim even with leave of court. “To the extent that a trustee is immune from suit, a trustee's attorney is also immune.” *Id.*, citing *Bay Area* at *5; *Smallwood v. U.S.*, 358 F.Supp. 398, 404 (E.D.Mo.1973), *aff'd mem.* 486 F.2d 1407 (8th Cir.1973); *Mullis v. U.S. Bankruptcy Court*, 828 F.2d 1385, 1390 (9th Cir.1987), *cert. denied*, 486 U.S. 1040, 108 S.Ct. 2031, 100 L.Ed.2d 616 (1988). The court held that Trustee and Attorney were not immune from suit under the quasi-judicial immunity doctrine, but held that they were immune under the litigation privilege.

The litigation privilege is a "long-standing common law rule that communications uttered or published in the courts of judicial proceedings are absolutely privileged." *Circus Circus Hotels v. Witherspoon*, 99 Nev. 56, 657 P.2d 101, 104 (1983). The policy behind the rule is to grant attorneys and other participants in judicial proceedings "the utmost freedom in their effort to obtain justice...." *Id.; see also Rodriguez v. Panayiotou*, 314 F.3d 979, 988 (9th Cir.2002) (privilege applies to any communication with some logical relation to a judicial or quasi-judicial proceeding made by a litigant or other participant in the proceeding). The privilege is a bar to a defamation claim even if it is alleged that the defamatory statements were made with knowledge of their falsity and with personal animosity toward the other party. *Id.*

As stated in *Fink*, "[t]he scope of the absolute privilege is quite broad." *Id.*, 49 P.3d at 644. To be protected, the defamatory communication need not be relevant to the proposed or pending litigation; it need only be related in some way to the subject of the controversy. The privilege applies to communications outside of court and those made before litigation has commenced as well as those made during actual judicial proceedings. *Id.*

*Id.* at 689-90.

**In re Lowenbraun, 453 F.3d 314 (6th Cir. 2006)**

In this case, the chapter 7 trustee commenced an avoidance action against the debtor and his ex-wife on the basis that the debtor and ex-wife had engaged in fraudulent transactions in their divorce proceedings. The parties agreed to a settlement, whereby the spouse agreed to transfer $1 million to the estate, placing it in an account in the name of the debtor, who would then transfer the money to the trustee. Upon transfer to the debtor’s account, the debtor absconded with the money. A reporter interviewed counsel for the trustee and published an article suggesting that the ex-wife had conspired with the debtor and had committed bankruptcy fraud. The ex-wife then sued the trustee’s counsel based on these published statements.

After finding that the Barton doctrine (discussed below) applied, the Sixth Circuit found
that the trustee and counsel for the trustee were immune from suit under Kentucky law. Under Kentucky law, statements made in pleadings filed in judicial proceedings are absolutely privileged when material, pertinent, and relevant to the subject matter under inquiry. Further, these statements protected by the absolute privilege did not lose their privilege merely because they were reported in the newspaper. The record was unclear as to whether the published article merely repeated information available in the pleadings and discussed at court hearings or whether the trustee’s counsel provided additional information to the reporter. Even if the published article contained additional information provided by trustee’s counsel, the ex-wife offered no evidence to suggest that there was bad faith or that the information did not serve a public purpose.


In *Denton*, counsel for the chapter 13 debtor moved to hold the trustee in contempt for his alleged overpayment of secured creditors in a manner that resulted in the counsel receiving no fee. The counsel did not seek damages for the alleged contempt, but rather requested entry of an order directing the trustee to correct the payments according to the plan and to continue to disburse correctly in the case as well as all others administered by the trustee. The court found that the trustee was absolutely immune, either from liability in damages, or from injunctive relief, based on the disbursement errors that the trustee made during her administration of the case. Here, the trustee’s disbursement errors occurred during her administration of the bankruptcy case. The trustee inadvertently overpaid secured creditors when she attempted to conform her computerized disbursement calculations to the plan and to the BAPCPA disbursement scheme set out in a *bankruptcy court order* entered in another case. The trustee’s exercise of discretionary judgment in attempting to reconcile the conflicting disbursement schemes with the debtor’s plan and with an order from the court was functionally comparable to the discretion exercised by judges. Thus, the trustee could not be sued for her disbursement errors.

**Harris v. Wittman (In re Harris), 2007 WL 2456202 (S.D.Cal.)**

In *Harris*, the court stated that the actions of a trustee in selling estate assets is the type of action that will be entitled to immunity. In this case, the debtor filed a complaint against the trustee alleging breach of contract against the trustee and her agents. The relevant actions performed by the trustee included transferring and selling assets of the estate. Since *Castillo* had already established that trustees are entitled to immunity, the court in Harris did not carry out an analysis of whether the trustee was historically afforded immunity, but simply asked whether the sale of assets was an adjudicative function, and answered in the affirmative. The court stated that those functions are essential to the authoritative adjudication of private rights to the bankruptcy estate. However, the court also stated that its conclusion was further supported by the fact that the bankruptcy court had approved the sale of assets at issue. Thus immunity was granted.26

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26 The summary of *Harris* was provided by the court in *In re Continental Coin Corp.*, 380 B.R. 1 (Bankr.C.D.Cal. 2007) (trustee’s attorney did not owe a statutory or fiduciary duty to the creditors of the estate. However, the creditor would be granted permission to file amended complaint against trustee, but only for alleged acts of gross

Heinsohn involved a trustee who was sued by a non-debtor for malicious prosecution and defamation in referring the case to the United States Attorney for investigation and prosecution following the plaintiff's acquittal on charges of bankruptcy fraud. Fortunately, the court held at page 64 as follows:

Based on the foregoing analysis that the function performed by a bankruptcy trustee in reporting possible criminal violations to the United States attorney is judicial in nature, that there are adequate safeguards to reduce the possibility of harm to an innocent party, and that subjecting a trustee to liability in this instance would deter the trustee from complying with his obligations under 18 U.S.C. §3057, this court concludes that the defendant is protected by absolute immunity from the plaintiff's malicious prosecution action.

In re Center Teleproductions, Inc., 112 B.R. 567 (Bankr. S.D. N.Y. 1990), provided an exception to those decisions granting trustees absolute immunity when acting pursuant to court order. In this case, a tenant of property sold at auction brought suit to hold the trustee and the auctioneer personally liable for its losses. It was alleged that the trustee was not entitled to judicial immunity because he had misrepresented the facts to the court in obtaining the order for the auction sale. The Court reviewed many of the cases cited above, and concluded, "[A] bankruptcy trustee is immune from suit for personal liability for acts taken as a matter of business judgment in acting in accordance with statutory or other duty or pursuant to court order." However, the court added a significant "loophole". "Where the trustee negligently fails to discovery his agent's negligence, negligently obtains a court order, or negligently or willfully carries out a court order he knew or should have known he wrongfully procured, however, personal liability will attach." Yet, the Center court reasoned that in such cases, the proper remedy is, "to appeal, not to collaterally attack the order."29

In In re Washington Trust Deed Service Corporation, d/b/a Lincoln Mortgage & Loan, 224 B.R. 109 (9th Cir. BAP 1998) the court found that the trustee was not protected by quasi-judicial immunity where he fraudulently misrepresented his intentions upon entering into a settlement agreement which he later withdrew from after concluding it was not in the best interests of the estate. The court states as follows:

Ultimately, it is lack of court approval, rather than the absence of (the trustee's) support, negligence or willful and deliberate violations of trustee’s duty of care as a fiduciary) Continental Coin provides an excellent discussion of judicial immunity.

27 112 B.R. at 578.

28 Id.

29 Id. at 577.
which caused (the) damages. Having not alleged that, but for the trustee's change of position, the bankruptcy court would have approved the settlement, his complaint does not state a cause of action under California law.

\[\text{In re XRX, Inc., 77 B.R. 797 (Bankr. D. Nev. 1987), further declared that even where a trustee makes an erroneous disbursement of funds to pay administrative expenses, he is not subject to personal liability when he acts pursuant to court order. Further, the XRX court stated that "it was entirely inappropriate for [the plaintiff] to initiate this action against [the trustee] personally."}\]

**IV. TRUSTEE LIABILITY: PRE-CODE PERSONAL LIABILITY**

**A. THIRD PARTY LIABILITY**

A scholarly article was written in 1978 by E. Allan Tiller, Esq. entitled, *Personal Liability of Trustees and Receivers in Bankruptcy*, 53 AM. BANKR. L.J. 75, 98 (Winter 1978). Mr. Tiller's article provides an excellent overview of the law as it existed about the time the Code was enacted. A brief review of the article follows, together with comments regarding selected, pre-code cases.

The article divides personal liability into two distinct categories: (1) liability to third parties unconnected with the bankruptcy proceedings, and (2) liability to the estate and interested parties.

With respect to the former, it is generally acknowledged that the law was developed in the leading case of *McNulta v. Lochridge*, 141 U.S. 327, 332 (1891). The principle developed in that case is now known as "the McNulta Rule". Essentially, the McNulta Rule states that actions against receivers are actions against the receivership, and are payable only from receivership funds. It states that a receiver's liability is "official not personal." The McNulta Rule has been adapted to bankruptcy trustees.\[^{31}\] In *McRanie v. Palmer*, 2 F.R.D. 479 (Mass. 1942), the court stated: "[R]eorganization trustees, as receivers, are liable only in their official capacities for torts occurring during their management of the debtor's property. They are not personally liable, as would be ordinary trustees."\[^{32}\]

However, the McNulta Rule only limits personal liability of trustees to third parties--it does not eliminate it. A distinction is often drawn between liability for wrongful acts committed outside the trustee's scope of authority and immunity for actions committed under the authority of a Bankruptcy Court. A leading case establishing this principle is *Smallwood v. U.S.*\[^{33}\] In

\[^{30}\] 77 B.R. at 798.

\[^{31}\] See, Zeigler v. Pitney, 139 F.2d 595, 596 (2d Cir. 1943).


Smallwood, the plaintiff, who was imprisoned following a securities fraud conviction, alleged that the trustee conspired with the trustee's attorneys to deprive him of "liberty and property." The court dismissed the action stating:

[S]ince [the trustee] was elected, duly appointed and qualified as Trustee in Bankruptcy, . . . he must also be treated as a judicial officer. Since [the trustee] had [no] contact with Plaintiff in any manner other than in [his] official capacity, it necessarily follows that [he] is . . . immune from suit.34

B. LIABILITY TO THE ESTATE AND ITS CREDITORS

Mr. Tiller further comments at page 89 that, "While the McNulta rule governs liability to third persons, it has no relevance to liability to interested parties." He reports at page 91 that bankruptcy officers have been found personally liable primarily in cases based on violation of their fiduciary duties to collect, preserve, and distribute the estate. Additionally complex, misunderstood and randomly enforced tax and environmental laws have become issues that every trustee faces routinely.

The standard of care for trustees in cases involving interested parties is paramount to this discussion. Decisions which endeavor to establish the standard of care range from those applying a mere negligence standard to those that require willful misconduct. In re Johnson, 518 F.2d 246 (10th Cir. 1975), held that "the standard applicable to the surcharge of a bankruptcy trustee is negligence." Some courts still follow the earlier rule established in In re Marcus, 2 F. Supp. 524 (W.D. Pa. 1932) that "a receiver is liable to surcharge only when guilty of fraud or supine negligence equivalent to fraud." Evans v. Williams, 276 F. 650 (6th Cir. 1921) reasoned ". . . [the trustee's] liability must be based upon his gross and culpable negligence and misconduct. . . ." Other courts have virtually ignored the question of whether ordinary or gross negligence exists and have based personal liability on a willful and deliberate act in violation of the trustee's fiduciary duties.

The United States Supreme Court has not tackled the precise issue of trustee liability since 1951. In Mosser v. Darrow, 341 U.S. 267, 71 S.Ct. 680, 95 L.Ed. 927 (1951), the Court issued what the dissent characterized as a “rule of trustee liability [that] did not exist before today, as is shown by the fact that no statute or case is cited in support of the court's decision.” 341 U.S. at 275, 71 S.Ct. at 684. In so doing, the Court issued its last discourse on the scope of a trustee's liability for acts done while administering a bankruptcy estate. The opinion has engendered much confusion concerning the extent to which a claim against a trustee is, in fact, a

34 Id. at 404.
35 518 F.2d at 250.
36 2 F. Supp. at 525.
37 276 F. at 655.
38 See, Sherr v. Winkler, 552 F.2d 1367 (10th Cir. 1977).
claim against the estate, or, put another way, the extent to which a trustee can be personally liable for acts done while acting as trustee.

Darrow was the reorganization trustee for two trusts. He hired two trust insiders, Kulp and Johnson, to help him reorganize the businesses. One of Darrow's reorganization strategies was to buy up the outstanding bonds of various subsidiary companies at a substantial discount. One of the terms of the agreement by which Kulp and Johnson agreed to work for him was that they would be allowed to conduct trade in these bonds on their own behalf. This fact was not disclosed to the court or to the trustee's counsel. Kulp and Johnson often bought bonds from holders who had come to sell them to Darrow and would later sell the bonds to Darrow at a substantial profit. After several years, the SEC intervened in the case and demanded an investigation into Darrow's activities as trustee. Darrow resigned and filed his final reports and accounts. Mosser, the successor trustee, objected to approval of those reports. He claimed that Darrow's tolerance of the insiders' activities had cost the estate $43,000 and that Darrow should be held personally liable for the lost income. 341 U.S. at 268-70, 71 S.Ct. at 681. The Supreme Court held Darrow personally liable to the estate for the income diverted to the insiders, despite the fact that he had not benefitted from their actions. Id., at 275, 71 S.Ct. at 684.

The Court began its analysis by observing that a trustee is a representative of the court and must be held to a strict standard. Id., at 271, 71 S.Ct. at 682. Further, because self-interests are “always corrupting” (though not always corrupt), “These strict prohibitions would serve little purpose if the trustee were free to authorize others to do what he is forbidden.” 341 U.S. at 271, 71 S.Ct. at 682. Upon this observation, the Court concludes: “We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself.” Id., at 272, 71 S.Ct. at 682. As noted above, the Court fashions a remedy for such actions, though the trustee himself profited not at all, in great part to forestall future conduct such as was before it. “The most effective sanction for good administration is personal liability for the consequences of forbidden acts, and there are ways by which a trustee can effectively protect himself against personal liability.” Id., at 274, 71 S.Ct. at 683. (“A further remedy for limiting, if not avoiding personal liability is to account at prompt intervals, which puts upon objectors the burden of raising their objections.” Id.)

By its opinion the Mosser Court reversed the Court of Appeals, which had concluded that no personal liability against the trustee should attach. Crucial to unraveling the confusion that has ensued from the opinion is to understand just what the Supreme Court reversed. In its opinion, Darrow v. Mosser, 184 F.2d 1 (7th Cir.1950), the Court of Appeals cited numerous treatises for the proposition that a trustee who uses due diligence or reasonable care in the selection of employees is not liable to beneficiaries for the negligence or dishonesty of the employees if reasonably prudent in the supervision of them. 184 F.2d at 7. As well, Darrow offered numerous bankruptcy cases supporting the proposition that if the trustee is not derelict in the hiring, a surcharge will not be imposed if the employees turn out bad. The generalized conclusion of the authority offered by the trustee is that if a trustee acts within the scope of his authority, he is not chargeable with losses to the estate through the acts of others, and he is personally chargeable only if guilty of personal fault in the nature of fraud or “supine negligence equivalent to fraud.” 184 F.2d at 8-9. (The Court points out that the reference to “supine
negligence equivalent to fraud” is a reference to *Taylor v. Benham*, 46 U.S. (5 How.) 233, 12 L.Ed. 130 (1847). In that case the Supreme Court says, in connection with a claim against an executor for losses over the sums received by the executor, “When a trustee is liable for more, it must be, in the language of the books, ‘in cases of very supine negligence or willful default.’” 46 U.S. at 275.)

The Court of Appeals concludes that simple negligence is not sufficient to establish that a trustee sufficiently breaches his obligation of due diligence and care in the administration of the estate to suffer personal liability, and if anything, simple negligence is all that had been established. Therefore, the surcharge issued by the lower court was reversed. Now, two things in addition shed light. First, the Court does not suggest that Darrow was not negligent, and in fact points out that a certain portion of the successor trustee's claim was reserved for future proceedings. In this regard the court notes that Darrow's “failure to file reports showed a woeful neglect of duty.” 184 F.2d at 10. Not subject to the successor trustee's cross-appeal was the request to impress upon certain assets a resulting trust arising from these acts of negligence, and as well to assess additional surcharge. The resulting trust request is tantamount to a claim that the estate is to be maintained and made whole by the imposition of a resulting trust. As well, there is the possibility of other surcharge (maybe woeful negligence is equivalent to supine negligence equivalent to fraud). Second, the Court predicts the Supreme Court's reversal of its opinion through a reference to *Magruder v. Drury*, 235 U.S. 106, 35 S.Ct. 77, 59 L.Ed. 151 (1914), a case involving a trustee whose firm acted as broker of a sale of trust securities, earning a profit on the sale. Though guilty of no “wrongdoing” the trustee was required to return the profit he had earned as a result of the general prohibition upon a trustee profiting from the trust's business. Though this conclusion is seen as being of no import, the Court also notes that the argument that “he should be surcharged for allowing his agents and employees to make profits he could not himself make in equity,” 184 F.2d at 10, is devoid of authority and is to be dismissed. (As we have seen and will see, the absence of authority was no hurdle for the Supreme Court.)

Darrow's argument, based upon the Court of Appeals' decision, was that while a bankruptcy trustee could be held liable only upon a showing of fraud or supine negligence, personal liability here would require the conclusion that simple negligence would suffice for such a surcharge. The Supreme Court disagreed:

> We see no room for the operation of principles of negligence in a case in which conduct has been knowingly authorized ... The question whether he was negligent in not making detailed inquiries into their operations is unimportant, because he had given a blanket authority for the operations. The liability here is not created by a failure to detect defalcations, in which case negligence might be required to surcharge the trustee, but is a case of a willful and deliberate setting up of an interest in employees adverse to that of the trust.

341 U.S. at 272, 71 S.Ct. at 682.

What is the Supreme Court saying in this last sentence? Some of it is clear. If a trustee intentionally constructs, either personally or by means of employees, a set-up by which he or his
employees can profit from trust business, the trustee will be surcharged, personally, to return the profits to the estate. However, what is not clear is whether the Court is also embracing personal liability arising from plain garden-variety negligence. There can be two interpretations: (i) in issues involving failure to detect defalcations, it is possible to assess the trustee personally for the damage, or return of profits, upon a showing that simple negligence caused harm; (ii) in light of prior jurisprudence protecting the trustee personally unless guilty of fraud or supine negligence, if what was before the court (as the Court of Appeals thought) was failure to detect defalcations, the trustee might be correct in his argument that to surcharge personally, the court would have to say simple negligence is now sufficient (but because that is not what the court is dealing with, the question is moot). As we shall see, the Mosser case and issues therein, never again revisited by the Supreme Court, have generated a variety of views among the circuits facing questions of trustee liability. Although the circuit courts that have interpreted Mosser fail to agree on its meaning, they all agree on two points. First, the standard of care that Mosser imposes on a bankruptcy trustee is that of an ordinarily prudent man in the conduct of his private affairs under similar circumstances and with a similar object in view. Second, although a mistake of judgment is not a basis for liability, a failure to meet the standard of care will subject the trustee to liability of some kind.

However, Mosser has proven to be an inconclusive case, and has been subsequently cited by courts across the country in support of many divergent positions on the standard of care governing trustee personal liability. What results is a "crazy quilt" of decisions in the federal judicial circuits following the enactment of the Code which apply equally to bankruptcy trustees and DIPs.

V. TRUSTEE LIABILITY: PERSONAL LIABILITY FOLLOWING ENACTMENT OF THE CODE

A. THREE WAY CIRCUIT SPLIT ON STANDARD OF CARE

The issue of the personal liability of bankruptcy trustees arises in two contexts: (1) the acts or omissions of the trustee in operating the debtor’s business or managing the debtor’s property, which causes injury to the third party plaintiff; and (2) the trustee’s violation of his or her fiduciary duties to the estate, the creditors, or shareholders. A trustee who acts within the scope of his or her authority in performing a judicial function with the benefit of an authorizing and properly noticed court order, performs his or her duties with the benefit of judicial immunity. Derived judicial immunity should not be considered applicable to the question of the standard of care – it is applicable only in a limited capacity when the trustee is acting in the performance of a “judicial” function. Personal liability of a trustee vis-à-vis the outside world should be limited to instances in which the trustee is acting outside of the course and scope of his duties as trustee; otherwise, the trustee acts in a representative capacity as representative of the estate, and the trustee’s conduct is the estate’s conduct. The estate might be liable, but the trustee is not. We believe that you should look to general principles of representative liability to determine the extent to which a trustee can be liable to the outside world. With respect to the question of trustee’s personal liability for breach of duty to the estate, the question of the appropriate standard of care is relevant.
A number of Circuit Courts of Appeals have adopted the intentional and deliberate standard, holding that a trustee in bankruptcy should not be held personally liable unless he acts willfully and deliberately in violation of his fiduciary duties. See, e.g., In re Chicago Pacific Corp., 773 F.2d 909, 915 (7th Cir.1985); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461-62 (6th Cir.1982); Sherr v. Winkler, 552 F.2d 1367, 1375 (10th Cir.1977). On the other hand, In re Cochise College Park, Inc., 703 F.2d 1339, 1357 (9th Cir.1983), imposes liability upon a trustee for mere negligence.

It is believed that the last standard of care discussed – the gross negligence standard of care - strikes the proper balance between the difficulties of the task assumed by trustees and the need to protect the interest of creditors and other parties in the bankruptcy case. As discussed earlier, the real question is whether the trustee is personally liable for damages done to the estate. It is perhaps the posture of the claimants in the various cases that has resulted in the differing lines of analysis. Recall that the Mosser claim was brought by a successor trustee on behalf of the estate for damage done to the estate. The question was "To what extent will a trustee be personally liable to the estate (or creditors of the estate) if damage is done to the estate (or the interest of a creditor in that estate) as a result of his administration?" This is the question presented by Cochise, Gorski, etc. Either a trustee will be liable personally, or there will be no liability at all. If damage is done to the estate, then the estate cannot be held liable for that damage to its creditors (or itself).

1. Intentional and Deliberate Standard (or “Knowing” Standard)

Tenth Circuit

Sherr v. Winkler, 552 F.2d 1367 (10th Cir. 1977)

The intentional and deliberate, or “knowing” standard was articulated by the Tenth Circuit in Sherr. The Tenth Circuit interpreted Mosser v. Darrow to hold “that a reorganization trustee would not be liable personally except for willful and deliberate acts.” 552 F.2d at 1375. The court went on to hold that a trustee may be “held liable in his official capacity and thus surcharged if he fails to exercise that degree of care required of an ordinarily prudent person serving in such capacity, taking into account the discretion allowed.” Id. The term “surcharge,” according to the court, meant that the damages resulting from trustee negligence would be paid only from the funds of the estate, and not from the trustee’s own assets. The court should have stated that the damages would be paid as an administrative expense (rather than using the term “surcharge”). The Tenth Circuit’s use of the term “surcharge” has caused problems among courts. As noted by the Ninth Circuit in Cochise Park (discussed below), the term “surcharge” itself means to impose “personal liability on a fiduciary for willful or negligent misconduct in the administration of his fiduciary duties.”


Trustee owed no fiduciary duties to the debtor, where the estate was insolvent. Trustee's

conduct in distributing funds to the debtor's ex-wife did not rise to a level of negligence, let alone of any willful and deliberate misconduct, of the kind needed for the trustee to be deemed personally liable. Further, the trustee was immune from suit for any actions taken pursuant to a court-approved settlement agreement.

4th Circuit

*United States v. Sapp, (In re S. Found Corp.), 641 F.2d 182 (4th Cir. 1981).*

Lessee attempts to sue trustee for negligent failure to pay claim for services furnished debtor in course of the debtor’s business. Trustee not liable because there was no intentional and deliberate conduct. Trustee not liable on his bond.

*Yadkin Valley Bank & Trust Co. v. Ling McGee, Trustee, 5 F.3d 750 (4th Cir. 1993),*

In *Yadkin*, the Fourth Circuit court decided that although the Code imposes specific duties on bankruptcy trustees, the Code does not explicitly make trustees liable for breach of those duties. 40 The court further stated that the source of trustee liability lies in the Supreme Court's decision in *Mosser*. While this case does not squarely alter the standard of care in the 4th Circuit (personal liability only for willful and deliberate violations), which was established in *Sapp* it does expand the standard of care in unexpected ways while highlighting the risky nature of the business of a bankruptcy trustee. The district court states at pages 753 and 754 as follows:

In fact, the duty to close the estate expeditiously is the trustee's "main duty," 4 Collier on Bankruptcy, [], §704.01(3) at 704-5 and "overriding responsibility," Estes & Hoyt v. Crake (In re Riverside - Linden Ins. Co.), 925 F.2d 320, 324 (9th Cir. 1991) . . . the duty to close the estate expeditiously will often conflict with other duties, In re Melenyzer, 140 B.R. 143, 155 (Bankr. W.D. Tex. 1992), but this conflict is explicitly recognized in the text of the statute itself, which requires the bankruptcy trustee to balance the need for expeditious conduct against the "best interests of parties in interest," 11 U.S.C. §704(1). . . . So construed the statute itself provides the necessary standard of care.

*McGahren v. First Citizens Bank & Trust Co. (In re Weiss), 111 F.3d 1159 (4th Cir. 1997).*

Suit by debtor’s former business partner against trustee for trustee’s alleged failure to seize property and sell earlier rather than belatedly abandon property to former business partner when there was no more equity left in property. Court found no willful or intentional misconduct. We think that the court should have first addressed whether a duty was even owed to the former business partner.

40 See, 5 F.3d at 752.
6th Circuit

*Ford Motor Credit Co. v. Weaver*, 680 F.2d 451 (6th Cir. 1982).

Debtor in possession could not be held personally liable for negligence and could only be liable to creditor for intentional and deliberate conduct. Here, the debtor-in-possession sent notices to incorrect address, causing a situation where the creditor was not notified of the bankruptcy proceedings. The court remanded the case for a factual determination of whether the failure to correctly list a creditor's address on the bankruptcy schedules, causing a situation in which the creditor was not notified of the proceedings and thus could not file a proof of claim and could not share in the bankruptcy distribution, constituted such a willful and deliberate violation.


A secured creditor brought adversary proceeding in name of United States against Chapter 7 trustee and surety on blanket bond covering Chapter 7 panel trustees, alleging that trustee breached duty by failing to procure insurance on estate assets. The court stated that the standard of a trustee's acting "faithfully", as set forth in the trustee's bond, is equitable with the standard of negligence. One who "negligently" performs an official duty does not "faithfully" perform it. If the trustee is negligent in performing his duties, then the bonding company is required to pay on the standard of mere negligence, and then would be allowed to sue the trustee personally in contract. The court denied the trustee’s motion for summary judgment because there were disputed material facts. This ruling may effectively circumvent the rule of law established in the Sixth Circuit in 1982 and reaffirmed in 1986 that a bankruptcy trustee is personally liable only for willful and deliberate violations of the law outside the scope of authority granted by statute. What purpose will be served by such apparent protection if bonding companies are required to pay on the standard of mere negligence and then be permitted to successfully sue trustees personally in contract?41

7th Circuit

*In re Chicago Pacific Corp.*, 773 F.2d 909 (7th Cir. 1985).

Here, the court discusses trustee liability vis-à-vis the world (in this case, the minority vendors). The court found that the trustee of the debtor railroad owed no fiduciary duty to the minority vendors with regard to alleged discrimination, and thus, the complaint charging the complaint charging the trustee with discrimination for the refusal to allow minority vendors to provide goods and services did not state a cause of action against the trustee in his personal

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41 But see, *In re Susan Kaufman d/b/a Bellezza Ristorante*, 2 Alaska Bankr. Rep. 10 (D. Alaska 1991) an unpublished opinion regarding a trustee negligence action, which holds at page 13 "The (trustee) bond does not apply to cases of negligence, it is not a trustee malpractice insurance policy").
capacity.


In this case the court cited at pages 187 and 188 the Melenyzer and the Cochise College Park, Inc. cases stating:

Although a trustee will not be liable for misjudgments in matters where discretion is allowed, "he or she may be held liable for both negligent and intentional violations of the duties imposed upon him by law." . . . Further, even though the trustee has no obligation to investigate every matter that is brought to his or her attention, the trustee is statutorily required to look into charges of concealment of assets, fraudulent conduct, and any other wrongdoing by the debtor or third parties.

The court decided in this case that the bankruptcy trustee's failure to act affirmatively, upon learning of misappropriated estate assets, is negligence and a breach of his or her fiduciary duty to the estate.


In this case, trustee commenced several actions against the Debtor. The court found that none of the actions had any merit. The debtor sought to reimbursement for its costs and attorney fees incurred in defending itself in the meritless litigation. The bankruptcy court had found that *Reading Co. v. Brown*, 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968) applied and found that the debtor's claim should be allowed as an administrative claim on the grounds of fundamental fairness. The district court agreed. The decision in *Reading* called for "fairness to all persons having claims against the insolvent." 88 S.Ct. at 1763. Although *Reading* involved a tort claim against the estate, the doctrine has been extended beyond the tort context. In *Yorke v. N.L.R.B.*, 709 F.2d 1138 (7th Cir.1983), the Seventh Circuit cited *Reading* for the proposition that those injured during the administration of the estate by the trustee are entitled to priority as an administrative expense. 709 F.2d at 1143. Several courts have applied *Reading* to award attorney's fees and costs resulting from the trustee's frivolous litigation. See *In Re Airwest International*, No. 86-00145, 1988 WL 113101 (Dist. Hawaii October 12, 1988), citing *In Re E.A. Nord Co., Inc.*, 78 B.R. 289 (Bankr.W.D.Wash 1987); *In Re Charlesbank Laundry, Inc.*, 755 F.2d 200 (1st Cir.1985); In Re Chicago Pacific Corp., 773 F.2d 909 (7th Cir.1985). The court found in the present case that the debtor should be reimbursed for court costs and attorney fees. These expenses would be considered an administrative expense.

2. Mere Negligence Standard

9th Circuit

*Hall v. Perry (In re Cochise College Park, Inc.)*, 703 F.2d 1339 (9th Cir. 1983).
Cochise Park was a case in which the court held a trustee liable for negligent and intentional violations of duties imposed by law. In Cochise Park, the Ninth Circuit disagreed with Sherr. It held that a trustee is subject to personal liability not only for intentional but also negligent violations of duties imposed upon him by law. 703 F.2d at 1357. The standard of care, known as the “simple” or “mere” negligence standard has been used by courts to impose personal liability on trustees. As the court in Carter Paper, 220 B.R. 276 (Bankr.M.D.La. 1998) stated, if the standard of care should be that a trustee is personally liable for simple negligence, then there is no need to determine whether the trustee’s liability is representative – there will never be a claim against the estate.

Typical of contrary decisions is one made several years later. In In re Creative Cuisine, Inc., in which the court ruled that a debtor-in-possession, which has "the rights, powers, and duties of a trustee serving in a Chapter case," had no personal liability. It stated that "personal liability will be imposed on trustees...only if they deliberately breach their fiduciary duties or act outside their authority."

U.S. v. Hemmen, 51 F.3d 883 (9th Cir. 1995).

In this case the court held that the trustee, who was the recipient of an IRS notice of levy at a time when the estate had assets which were not liquidated, was personally liable under 26 C.F.R. §301.6332(c)(1) for failure to honor the levy. The court stated further that it was aware of the added burden on bankruptcy trustees, but that a contrary conclusion would impose an additional burden on the IRS’ ability to expeditiously collect delinquent taxes, despite the IRS' failure to object to the proposed distribution or to otherwise alert the trustee to the consequences of same. The court also concluded (perhaps to avoid overruling earlier contrary decisions) that the action of the trustee was either intentional or negligent and violated the trustee's legal duty to honor the levy.


Chapter 7 trustee filed application for allowance of fee, and United States Trustee objected thereto and moved to “surcharge” trustee for failing to invest estate funds in interest-bearing account. Case was remanded to court to determine trustee’s negligence in failing to invest funds. The court stated that the scope of the trustee's duty to invest estate funds, and the question as to whether that duty has been breached are not subject to a mechanical calculation. Rather, the practical considerations involved in defining trustee's duty to maximize the return on estate funds are: (1) the sum of funds subject to investment; (2) the duration of the trustee's administration of the estate; (3) the time required by the trustee to manage the transfer of funds; and (4) the frequency with which the trustee needs to access those funds. A trustee may incur liability for his or her failure to invest or deposit estate funds in an interest-bearing account when such investment or deposit is warranted.

Nash v. Kester (In re Nash), 765 F.2d 1410 (9th Cir. 1985)

After filing bankruptcy, the Nashes were successful in obtaining confirmation of a Chapter 13 plan. The Nashes owed their credit union approximately $6,500 which was secured by two vehicles. Pursuant to the plan, the Nashes were to make payments of $220 per month to the trustee for distribution according to the plan.

After the Nashes failed to voluntarily make the required plan payment, the bankruptcy court issued a wage deduction order requiring the Nashes respective employers to deduct the plan payment amount from the Nashes paychecks and transmit same to the Chapter 13 trustee. Thereafter, the Nashes moved the bankruptcy court for a dismissal of their Chapter 13 case. The court granted the Nashes request and entered an order dismissing the case.

The Chapter 13 trustee had accumulated, at the time of the dismissal, $907.14. After the dismissal, the trustee came into possession of an additional $50.59 from the wage deduction order. After the bankruptcy court issued the order dismissing the case, the Nashes immediately re-filed a chapter 13 petition, and claimed as exempt the funds in the possession of the trustee. The trustee, however, prepared his final report on the first case and distributed the funds to the credit union according to the first plan.

The Nashes sued the trustee and the credit union claiming the funds had been wrongfully distributed by the trustee and should be refunded to them. The bankruptcy court granted summary judgment in favor of the trustee and the credit union, and the district court affirmed. On appeal, the Ninth Circuit reversed.

The Ninth Circuit held that the funds received by the trustee after the dismissal of the first case but before the filing of the second case did not constitute property of the estate. As such, the funds should not have been available for distribution to any creditors and belonged to the Nashes.

The funds held by the trustee which he received prior to the dismissal of the case were property of the Nashes’ bankruptcy estate. However, the court reasoned, confirmation of a Chapter 13 plan vests ownership of property of the estate in the debtors.\textsuperscript{43} Moreover, a dismissal of the first Chapter 13 case “revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case.”\textsuperscript{44} Accordingly, the court concluded that the funds accumulated prior to the dismissal of the case belonged to the Nashes upon dismissal and should not have been distributed by the trustee.

Continuing, the court held that a trustee is accountable for all property received.\textsuperscript{45} Because the trustee is accountable, he is liable for the improper distribution of the funds. The court directed that judgment be entered in favor of the Nashes with an order directing the trustee to obtain a refund of the funds distributed to the credit union.

\textsuperscript{43} 11 U.S.C. § 1327(b).
\textsuperscript{44} 11 U.S.C. § 349(b)(3).
\textsuperscript{45} 11 U.S.C. §§ 704(2), 1302(b)(1)
The court in *In re Parrish*, 275 B.R. 424 (Bankr.D.D.C.2002), disagreed with *Nash* and held that upon dismissal of a chapter 13 case, § 349(b)(3)'s revesting language does not relieve the chapter 13 trustee of his statutory duty to distribute funds in accordance with a confirmed plan under § 1326(a)(2). The *Parrish* court went on to hold:

[A] debtor's title, under § 349(b)(3)'s revesting provisions, to funds that were paid pre-dismissal to a trustee under a confirmed plan is irrelevant: unless dismissal vacates the effectiveness of a confirmed plan (and nothing in the Bankruptcy Code says it does), § 1326(a)(2) requires the trustee to disburse the funds in accordance with the confirmed plan without regard to who holds title.

*Id.* at 429.

According to the court, interpreting these statutes otherwise would lead to an absurd and inequitable result that a debtor could "take the money that was earmarked for creditors and run after tying creditors' hands by reason of the confirmed plan having been in place." *Id.*

The *Parrish* court found that, because *Nash* had been decided under the prior version of § 1326, which did not contain any directive for the bankruptcy trustee to distribute plan payments in accordance with a confirmed plan, *Nash*'s holding had been superceded by statute.

However, the Ninth Circuit BAP addressed this very issue in *In re Tran*, 309 B.R. 330 (9th Cir. BAP 2004) and found that *Nash* still applied. It reasoned that § 1326(a)(2) was not intended to address the disposition of funds received by a chapter 13 trustee after confirmation. On appeal, the Ninth Circuit affirmed the BAP’s findings without an opinion. *In re Tran*, 177 Fed.Appx. 754 (9th Cir. 2006).


In *Continental Coin*, the court was of the opinion that *Cochise* does not stand for an adoption of the negligence standard. “While the *Cochise* holding appears very broad, it is clear from the facts of that case that the trustee was not negligent in the context of *Castillo*. He made certain decisions knowing that they would have a negative impact on the creditors. For example, he may have decided to allow the land sale contracts to be rejected by operation of law, but did not inform the other parties to those contracts and continued to collect payments. Although the *Cochise* court does not make any distinction and simply uses the term "negligence," the behavior that it condemns goes well beyond the simple negligence standard.”

2nd Circuit

*In re Gorski*, 766 F.2d 723 (2d Cir. 1985).

In *Gorski*, the Second Circuit upheld a “surcharge” against a chapter 12 trustee. The court imposed personal liability on him for failure to monitor the debtor’s performance of their
wage-earner plan. The lower court had found that the trustee's failure to carry out his obligations constituted “a material breach and default of his fiduciary duties and ... a negligent disregard of the rights and best interest of creditors.” Id. at 725. The issue on appeal was whether surcharge was appropriate. The court cited Mosser and Cochise for the proposition that: “In the usual case, a surcharge is imposed on the fiduciary in the amount of the actual or estimated financial harm suffered by either the creditors or the estate and is payable accordingly.” Id. at 727. Consequently, it affirmed the order surcharging the trustee, but reversed that part of the order which required that he pay the surcharge to the U.S. Treasury. The court said: “There is no question that a trustee in bankruptcy may be held personally liable for breach of his fiduciary duties. Such liability may attach as the result of negligent, as well as knowing or intentional, breaches.” Id. at 727 (citations omitted).

**Pereira v. Foong (In re Ngan Gung Restaurant), 254 B.R. 566 (Bankr. D.N.Y. 2000).**

After case was converted from chapter 11 to chapter 7, the chapter 7 trustee brought an adversary proceeding against the former chapter 11 trustee, seeking a determination that he was personally liable to the estate for the expenses arising from his acts or omissions during the administration of the chapter 11 phase of the plan. The chapter 11 trustee had deferred payment of some of the debtor’s taxes as they became due and allowed those expenses to accumulate. The court found that the trustee did not breach a fiduciary duty to the estate by deferring the expenses rather than converting the case to chapter 11, as there existed a reasonable prospect of rehabilitating the debtor.

**3rd Circuit**

**In re Sturm, 121 B.R. 443 (Bankr. D. Pa. 1990).**

The United States Bankruptcy Court for the Eastern District of Pennsylvania rendered a memorable decision in *Sturm*, when it reluctantly concluded that it would be obliged to impose liability on a trustee charged with mere negligence because it was bound to follow decisions in the Third Circuit which were over fifty years old[46] In this case, the creditor brought an adversary proceeding against the trustee and the bonding company for the trustee’s alleged failure to pay the creditor’s claim. The court found that the trustee could be “surcharged” or held personally liable for negligence in the administration of the estate. (Although it declined to find the trustee negligent.)

The *Sturm* court also outlined the state of the law in districts other than its own, stating at page 447:

> Unfortunately, our review of this subject reveals that significant differences exist among the Courts of Appeals and inferior courts, apart from those of our own Third Circuit, regarding the standards for determining when a trustee is immune from personal liability

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[46] See, In re Prindible, 115 F.2d 21 (3d Cir. 1940); In re Lambertville Rubber Co., 111 F.2d 45 (3d Cir. 1940).
from suit. A few courts have held that a trustee is personally liable "only for a willful and deliberate violation of his fiduciary duties." *In re Chicago Pacific Corp.*, 773 F.2d 909, 925 (7th Cir. 1985); *United States, etc.* v. *Sapp*, 641 F.2d 182, 185 (4th Cir. 1981); and *In re Tucker Freight Lines, Inc.*, 62 B.R. 213, 217 (Bankr. W.D. Mich. 1986). Cf. *In re San Juan Hotel Corp.*, 847 F.2d 931, 937 (1st Cir. 1988) (trustee held to have engaged in willful and deliberate violation of duties was held personally liable).

A larger number have held that a trustee may be "surcharged" or held personally liable for mere negligence. See *In re Gorski*, 766 F.2d 723, 727 (2d Cir. 1985); *Red Carpet Corp. of Panama City Beach v. Miller*, 708 F.2d 1576, 1578 (11th Cir. 1983); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1357 (9th Cir. 1983); *Ford Motor Credit Co. supra; Sherr v. Winkler*, 552 F.2d 1367, 1374 (10th Cir. 1977); *In re B.A. Montgomery & Son*, 17 F.2d 404, 406-07 (N.D. Ohio 1927); and *In re Consupak, Inc.*, 87 B.R. 529, 542 (Bankr. N.D. Ill. 1988). See generally, E.A. Tiller, *Personal Liability of Trustees & Receivers in Bankruptcy*, 53 Amer.Bankr.L.J., 75 93-96 (1978) (cited as "Tiller").

Since the Defendants in this case have attributed prominence to this court's Orders authorizing the distribution effected which excluded the Plaintiff's claim and closed the case after distribution, we must also consider the applicability of cases holding that "[b]ankruptcy trustees are entitled to broad immunity from suit when acting within the scope of their authority and pursuant to court order," *Bennett v. Williams*, 892 F.2d 822, 823 (9th Cir. 1989), and that, when a trustee is "acting under the authority of the bankruptcy judge, [he] is entitled to derived judicial immunity because he is performing an integral part of the judicial process. *Lonneker Farms, Inc.* v. *Klobucher*, 804 F.2d 1096, 1097 (9th Cir. 1986). See also *Mullis v. U.S. Bankruptcy Court for District of Nevada*, 828 F.2d 1385, 1390 (9th Cir. 1987); *Yadkin Valley Bank & Trust Col. (sic) v. McGee*, 819 F.2d 74, 76 (4th Cir. 1987); *Boullion supra; United States v. Eyges*, 286 F. 683, 684 (D. Mass. 1923); *In re Jacksen*, 105 B.R. 542, 544-46 (9th Cir. 1989); and *Tiller, supra*. 53 AMER.BANKR.L.J. at 98.

**In re Louis Rosenberg Auto Parts, Inc.  209 B.R. 668 (Bkrtcy.W.D.Pa.,1997).**

Secured creditor filed an adversary proceeding to recover from the chapter 7 trustee and on the trustee's bond for the trustee's alleged negligence in failing to see that the creditor's collateral was liquidated in timely fashion. The court stated that the "business judgment" rule, without more, did not shield the chapter 7 trustee from all liability in connection with the liquidation of the debtor's estate. The court explained that, because a trustee is a fiduciary, the
“business judgment” rule does not shield a fiduciary in the event that he has committed negligence.

11th Circuit

*Red Carpet Corp. v. Miller*, 708 F.2d 1576 (11th Cir. 1983).

The Court of Appeals held that bankruptcy court can deny an attorney for a Chapter 11 debtor in possession his fees on account of his wrongdoing or negligence but cannot additionally assess against him any money damages for losses due to such wrongdoing or negligence.


In *Ruff*, the Chapter 7 trustee employed a business broker pursuant to order. Following the sale of the business but prior to the entry of an order authorizing the broker's fees, the IRS served the trustee with a notice of levy for the broker's outstanding federal tax liabilities. Since the fees were not awarded at that time, the trustee reported that no funds were due the broker. He subsequently paid the broker after entry of the order. The district court found the trustee personally liable for the entire amount of the broker's fees and came dangerously close to awarding statutory prejudgment interest as well.


Chapter 7 debtor objected to the chapter 7 trustee’s fee application in a surplus case. The bankruptcy court held that the trustee’s fee would be reduced from the amount requested, based upon the trustee’s failure to maximize the return on estate assets by investing $245,000 settlement proceeds in a lower-interest money market account, and based upon the trustee’s delay in paying income taxes owed by the estate, which resulted in an additional $3,113.40 in interest and penalties.

*In re Happy Hocker Pawn Shop, Inc.*, 212 Fed.Appx. 811 (11th Cir. 2006).

In *Happy Hocker*, the trustee had shut down a pawn shop that he erroneously concluded held property of the debtor’s bankruptcy estate. The pawn shop owner filed an adversary proceeding in the bankruptcy court, requesting issuance of a declaratory judgment that the debtor had transferred its property interests in the pawnshop to the pawnshop owner ten months beforehand and that, as a consequence, the debtor no longer had an interest in the pawnshop. The complaint also requested injunctive relief prohibiting the trustee from interfering with the pawnshop’s business, ordering him to return the inventory that he confiscated, and ordering the pawnshop reopened. The bankruptcy court held an emergency hearing and found that the trustee had no right to take possession of the pawnshop. The trustee agreed to entry of a final judgment stating that the trustee had no right to take possession of the pawnshop’s assets. The agreed order, which stated that the trustee was acting out of the course and scope of its duties.

Shortly thereafter, the pawnshop owner requested leave to sue the trustee in state court to allege claims for trespass to property and personal property, conversion, and tortious interference.
with contracts for the purchase and sale of real property. The trustee objected to the motion, arguing that he did not exceed the scope of his authority as trustee, that his actions were consistent with his duties to protect the assets that the debtor listed on the bankruptcy schedules, and that he should be entitled to qualified immunity as a result. The bankruptcy court denied the trustee’s motion and granted the motion for leave on the grounds that it lacked subject matter jurisdiction to hear the lawsuit. On appeal, the district court and Eleventh Circuit affirmed.

The Eleventh Circuit found it undisputed that the trustee had committed an *ultra vires* act. The bankruptcy court had concluded in the judgment (agreed to by the trustee) that the trustee had committed an *ultra vires* act and had no right to seize the pawnshop owner’s assets. The Eleventh Circuit stressed that the bankruptcy court’s judgment, which was agreed to by the trustee, was never appealed and was thus a final order. The proposed complaint did not constitute a core proceeding because it did not allege tortious actions against property that was part of the bankruptcy estate.

Additionally, the Eleventh Circuit found that the proposed complaint did not invoke a substantive right created by bankruptcy law – Title 11 of the U.S.C. does not give bankruptcy trustees the right to seize property of a non-debtor. Further, the allegations against the trustee were grounded in state, rather than federal, law. The court also found that there was no “related to” jurisdiction that existed. The damages that the plaintiff sought would not come out of the debtor’s bankruptcy estate. The claims charged the trustee with wrongdoing in his individual capacity. “The bankruptcy estate would not be liable for [the trustee]’s acts. As the bankruptcy court concluded in the Agreed Final Judgment, [the trustee] had no authority to seize [the pawn shop owner]’s assets. He was acting outside the scope of his authority as trustee.” 212 Fed.Appx. at 818.

### 3. Gross Negligence Standard

#### 1st Circuit


The bankruptcy court in *In re J.F.D. Enterprises* discussed the problem with the willful misconduct and simple negligence standard and stated that “those courts which apply a simple negligence standard to the acts of a trustee underestimate the role of a trustee under the Bankruptcy Code and the difficulty associated with a trustee’s duties.” The court went on to explain: In chapter 7 cases and in chapter 11 cases where the debtor has been relieved of possession, trustees take on enormous responsibilities, and yet are sent into the fray without the most basic protections – that of sufficient historical knowledge of the debtor’s affairs. If the debtor is a business, the trustee will usually have little or no prior understanding of the industry in which the debtor operated. If further operation is required, the trustee will be expected to make decisions presumably sounder than those of the debtor’s principles. If a liquidation is the direction taken, the trustee will be expected to conduct that liquidation in a manner consistent with the industry in which the business operated. These duties and obligations are expected without the unconditional confidence or assistance of any other actor in the case, except for that
of her or his own agents. The court and the United States Trustee must remain disinterested. The
debtor and its principles certainly have no affection for the trustee. Secured creditors are the
trustee’s adversaries. Unsecured creditors demand of the trustee the due performance of the
trustee’s duties, amid their underlying concern that the trustee may object to their claims or seek
avoidance of transfers.

The J.F.D. bankruptcy court went on to state that trustees should not be deemed to
have violated their fiduciary duties and be subjected to personal liability unless they are found to
have acted with gross negligence. Further, it saw no reason to distinguish the standard of care to
which a chapter 11 trustee will be held from that applicable to a chapter 7 trustee. “Either may
be involved in running a business. Either may be involved in the liquidation of assets. Further,
tying the liability of trustees to that of directors and officers under state law leaves trustees too
vulnerable to changes under state law. Trustees need the assurance of a more stable standard to
which their actions will be held.”

5th Circuit


_Carter Paper_ analyzed the subject of personal liability of bankruptcy trustees. The
bankruptcy court recognized that some courts have held that a bankruptcy trustee is personally
liable for all acts of mismanagement or breach of fiduciary duty, while others have held that the
trustee is personally liable only for intentional acts of wrongdoing, and that he is liable "in his
official capacity" for negligent breaches of duty. “If the phrase "in his official capacity" carries
the same meaning as "in a representative capacity," then this second line of cases stands for the
proposition that a claim against a bankruptcy trustee for a negligent breach of his fiduciary duty
is a claim against the estate.” The bankruptcy court went on to discuss what the term “liability in
an official capacity” meant:

Under §§ 323(a) and (b), the trustee has the capacity to be sued as
a representative of the bankruptcy estate. Section 704 generally
sets forth trustee duties. At first blush, then, the phrase "liability in
an official capacity" is descriptive of liability of the bankruptcy
estate for actions of the bankruptcy estate, which can be
established by means of assertion of a claim against the
representative of the estate, the one with capacity to be sued.
Therefore, we understand the phrases "liability in an official
capacity" or "action against the trustee in his official capacity" to
mean "actions against the bankruptcy estate through the trustee."
Also, we understand the phrases to be exclusive of actions against,
and liability of, a trustee personally or individually.

_Id. at 290.

Suits in an official capacity, then, generate claims against the bankruptcy estate. However, according to the bankruptcy court, claims against the receiver for ultra vires acts, or
acts outside the scope of administration of the res, do not result in claims against the estate, but can be asserted against the trustee individually.

At the time the Carter decision was rendered, there was no opinion from the Fifth Circuit which addressed the issue of whether a bankruptcy trustee is personally liable for acts of negligence. Therefore, it was up to the bankruptcy court to determine whether the Sherr court or the Cochise court interpreted Mosser correctly.

If the Sherr court is correct, and a bankruptcy trustee is liable in his official capacity for acts of negligence, and if CPC's claim against Schott can be construed to include allegations of negligence, then the claim is a claim against the estate. If CPC's claim is one against the estate, then the administration-of-claims-prong of the bankruptcy process is implicated, and CPC has no right to a jury trial. If, on the other hand, Cochise is correct, and Schott is liable in his personal capacity for acts of negligence, then administration of claims is not relevant here, and the court must go on to determine whether CPC's claim comes within the scope of the second prong of the equitable bankruptcy process, the administration of the res.

With respect to the Sherr holding, the bankruptcy court noted that, despite the favorable citations from other circuits, critics claim that the case improperly differentiates between the surcharge of a trustee and personal liability, and cited one commentator regarding this issue:

This language is questionable, in that it tries to distinguish the surcharge of a trustee from personal liability while surcharge is in fact a means of imposing personal liability. In all the cases cited in the general discussion above concerning personal liability for loss to the estate in collection, preservation or distribution of the assets, surcharge and personal liability were synonymous.... the decision cites Mosser v. Darrow for the proposition that a trustee or receiver is 'liable personally only for acts determined to be wilful and deliberate in violation of his duties' and 'liable in his official capacity, for acts of negligence,' for which the trustee is surcharged. As explained earlier, Mosser made no such distinction. On the contrary, that case shows just the opposite, for while the trustee in Mosser was found personally liable for a wilful and deliberate act, the result was a surcharge of the trustee. Surcharge, in other words, was and is merely the means of imposing personal liability upon a bankruptcy trustee or receiver for loss to the estate. It is certainly not, as the Sherr decision states, a means of imposing liability in his 'official capacity' unless that phrase is to be given a meaning entirely opposite to which traditional definition, i.e., where the estate rather than the fiduciary is required to bear loss to the third persons ... Sherr v. Winkler, it seems, uses all the
language pertinent to personal liability of bankruptcy officers, but
the contradicting and confusing manner in which the court
arranged the language gives it poor potential as a case precedent.

*Carter Paper,* quoting Tiller, *Personal Liability of Trustees and Receivers in Bankruptcy,* 53

As well, the bankruptcy court found that the reasoning of the dictum in the *Sherr* opinion
was incorrect in that *Mosser* did not state that a trustee can be held personally liable only if he
has committed a willful or deliberate breach of his fiduciary duties.

However, the bankruptcy court also disagreed with the *Cochise* line of authority in that, it
too, had misread *Mosser*.

We think that the Mosser court made no determination concerning
whether run-of-the-mill negligence is sufficient to constitute
breach of fiduciary duty sufficient to warrant imposition of
personal liability, as it dispensed with any determination regarding
any level of negligence. We think it probable that the Court was
addressing Darrow's claim that surcharge would require a
modification of the supine negligence standard, and it was saying
that if failure to detect wrongdoing was the issue, perhaps (given
the profits generated for the estate and the overall apparent
soundness of the business practices employed) Darrow would be
right. Because it wasn't, he wasn't.

*Id.*

According to the bankruptcy court, the *Sherr* proposal of official capacity liability, as it
would be the same thing as estate liability, cannot exist with a claim against a trustee for damage
done to the estate. “Either the trustee is liable or he is not. If he is, then the estate derives the
recovery from the trustee's personal liability/surcharge; if he is not, then notwithstanding actual
damage to the estate, his level of problematic conduct is insufficient to warrant imposition of
personal liability.” The court then stated that the only claim that could be assessed against the
trustee in his official capacity would be a claim against the estate.

The court discusses *Reading Co. v. Brown,* 391 U.S. 471, 88 S.Ct. 1759 (1968) and
reasoned that the appropriate way to analyze trustee liability is from the perspective of who was
damaged. In the *Reading* case, post-petition tort claims by the owners of adjoining buildings
for damages due to a fire which spread from a building owned by the estate, gave rise to third
party claims against the estate for which the trustee bore no personal liability. However, tort
claims would lie in favor of prepetition creditors (and perhaps other interested parties) against
the trustee, personally, for damages done to the estate, if the trustee negligently failed to procure
insurance and the building owned by the estate was destroyed, giving rise to administrative

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claims which further dilute the creditors' claim values.\textsuperscript{48} For this reason determining the appropriate standard of care is necessary regarding actions against trustees by interested parties.

\textit{In re Smyth, 207 F.3d 758 (5\textsuperscript{th} Cir. 2000)}

After the \textit{Carter Paper} decision, the Fifth Circuit in \textit{Smyth} finally addressed the issue regarding trustee liability. The Fifth Circuit reviewed the split among the circuits and came down on the side of the rule requiring a showing of gross negligence and intentional conduct. The question in \textit{Smyth} involved whether the trustee incurred personal liability in his capacity as Trustee in a Chapter 11 case for damages incurred as a result of various errors on the estate’s tax returns. The Fifth Circuit reviewed the split among the circuits.

The Fifth Circuit expressly disagreed with the Ninth Circuit and adopted the analysis in \textit{J.F.D. Enterprises}. The Court relied heavily on the analysis in the National Bankruptcy Review Commission Final Report on this subject. Both the Court and the Commission recognized the disabilities under which trustees operate and their analysis accordingly gave the benefit of any doubt to trustees. Essentially, in tort terms, their analysis limited proximate cause to only causes resulting from gross negligence or intentional conduct.

We have commented upon the divergent case law, observing: 1) that \textit{Mosser} did not deal with negligent acts, and therefore, stands only for the proposition that a trustee whose intentional acts in administering an estate either causes damage or diminishes value by reducing earnings can be held liable, personally, to the estate, and; 2) that few, if any, post-\textit{Mosser} courts distinguish between actions for damage done to the world (by the bankruptcy estate) and damage done to the estate (by the trustee).\textsuperscript{49} We have concluded that those courts who consider \textit{Mosser} to be authority for the proposition that a trustee can be liable for damage to the estate for negligent acts are, simply, wrong, and that those courts that have misused Mosser have created an analytical construct wherein nobody can be right.

The Fifth Circuit, however, has correctly determined that \textit{Mosser} only dealt with intentional acts, and therefore, cannot be authority for negligence as the standard of care. In a case involving action for damage to the estate by alleged negligent acts of a trustee, the Fifth Circuit has clearly (and we think correctly) held that the applicable standard of care is that of gross negligence or willful breach of duty.\textsuperscript{50} Negligence, when analyzing a claim by the estate against a trustee is insufficient as a ground of liability.

Further, though we have had to discuss decisions involving questions of immunity along with the standard of care cases, the two questions are distinct. Immunity preserves the otherwise


\textsuperscript{50} \textit{Dodson v. Huff (In re Smyth)}, 207 F.3d 758 (5th Cir. 2000).
actionable conduct, but precludes suit due to policy grounds. Discussion of immunity should be separate from the discussion of the standard of care; if immunity is actionable, there can (need) be no standard of care analysis.

Basically, we conclude that immunity is probably not actionable when the trustee is performing a judicial function (the immunity would thereby be quasi-judicial) or when the trustee is acting pursuant to a court order, or directed (the immunity would be derived judicial immunity).


Chapter 7 trustee had asserted claims against the defendants, alleging that the defendants had stolen the debtor’s baseball training academy business. In their answers, the defendants asserted claims for attorney fees, but did not reserve the issue for determination subsequent to trial and presented no evidence of the amount of attorney fees at trial. The claims against the defendants were dismissed. After dismissal, the defendants sought reimbursement for attorney fees. The court found that the final judgment dismissing all claims raised in the proceeding precluded further consideration of attorney fees. However, even if the final judgment did not preclude consideration, the defendant’s had no claim against plaintiff’s counsel and had not properly asserted claims against the trustee, the trustee’s bond, or the estate. A. Claim against the bankruptcy estate. If the defendants sought to recover from the estate, they should have filed a proof of claim in the bankruptcy case. They did not file a timely proof of claim and the deadline for filing proofs of claim passed. If the defendants were seeking relief against the trustee in their personal capacity, they must allege gross negligence. The defendants did not allege gross negligence by the trustee and there were no facts in the record to support such an allegation.

8th Circuit  


Action for removal of chapter 7 trustee. Court stated: As fiduciary, bankruptcy trustee may be held liable for any losses proximately caused by his willful and deliberate violation of his fiduciary duties; however, trustee is not responsible for mistakes in judgment where that judgment was discretionary and reasonable under circumstances.


“[T]he trustee has an affirmative duty to rid the estate of such inconsequential property. _In re Carter Paper Co., 220 B.R. 276, 301 (Bankr.M.D.La.1998)._ Otherwise, the trustee's failure to abandon property of the estate properly may provide a basis for an action for breach of fiduciary duty, governed by a negligence standard. _Id._ However, negligence liability will not be imposed on trustees for mere mistakes in business judgment. _Naert v. Daff (In re Washington Trust Deed Service Corp.), 224 B.R. 109 (9th Cir. BAP 1998)._ The reasonableness of a trustee's decisions is evaluated "in light of the information that was, or reasonably should have been, available to him or her at the time. The standard ...
is 'reasonable care' and 'due diligence ....' " United States v. Aldrich (In re Rigden), 795 F.2d 727, 730-31 (9th Cir.1986), cited in Armstrong v. Harris (In re Harris), 886 F.2d 1011, 1013 (8th Cir.1989).

4. No Position

D.C. Circuit


B. CONFUSING IMMUNITY WITH STANDARD OF CARE

Although immunity and personal liability should be considered distinct, courts continue to confuse the two.


In this case a Chapter 7 trustee brought a malpractice action in state court against a large accounting firm. Shortly thereafter, pursuant to notice and abandonment, he abandoned a few hundred boxes of records which he felt were duplicative of other files in storage. Though the Notice was served upon all creditors, it was not served upon the defendant accounting firm. The firm learned of the abandonment, complained to the state court that it was entitled to review the records and to notification. In response, the state court not only held for the defendant, but ruled that it was entitled to fees and expenses. The defendant filed two motions, one against the trustee in his representative capacity and another against the trustee based upon his alleged personal liability. The opinion centered on the second motion, as well as the Barton doctrine which will be discussed later, presumably because the estate possessed little in the way of assets. The court could find no case in which the Eleventh Circuit had expressly ruled on the subject.

However, it appears from the cases that the alleged negligence must rise to the level of gross negligence to be actionable. See Cochise Park, 703 F.2d at 1339 ... In this case, the actions of Barbee do not rise to the level of willful and deliberate conduct or gross negligence. Barbee's actions were sloppy, positively; stupid, definitely; negligent, perhaps; but grossly negligent, not quite. After deeming the records burdensome to the estate and determining their value to be inconsequential, Barbee filed the requisite notice of abandonment ... A trustee is not liable in any manner for mistakes in judgment where discretion is allowed.

51 The inference being that no significant issues were raised regarding the motion against the Plaintiff (the trustee in his representative capacity) although the analysis presented later in this paper raises issues about whether the accounting firm was an interested party, thus making the first motion an action against the trustee personally.

52 But see, Red Carpet Corp. of Panama City Beach v. Miller, 708 F.2d 1576 (11th Cir. 1983).
The court also cited the *Markos Gurnee* case, and others, and pronounced:

A bankruptcy trustee has absolute quasi-judicial immunity from damages and derives his immunity from the judge who appointed him. *Naert v. Daff (In re Washington Trust Deed Service, Corp.)* 224 B.R. 109 (9th Cir. BAP 1998) citing *Mullis v. U.S. Bankr. Ct.*, 828 F.2d 1385 (9th Cir. 1987). For the purpose of litigation, a bankruptcy estate can sue or be sued, but only in the name of the trustee. 11 U.S.C. § 323. Such action involves the trustee's "official capacity" so that the estate, not the trustee personally, is liable. *Markos Gurnee*, 182 B.R. at 211. The Trustee is entitled to derived judicial immunity because he is performing an integral part of the judicial process ... Courts have devised a "safe harbor" for the protection of bankruptcy trustees as to personal liability. "A bankruptcy trustee is personally liable for breach of a duty to the estate or to creditors of the estate, but may protect against such liability by obtaining a court order authorizing contemplated action." *Markos Gurnee*, 182 B.R. at 218. Trustees "are completely immune from suit where the trustee acts pursuant to the explicit instructions of the bankruptcy court." *Lopez-Stubbe v. Rodriguez-Estrada (In re San Juan Hotel Corp.)*, 847 F.2d 931, 942 (1st Cir. 1988). As the Court found herein, Barbee, as Trustee, sought and obtained permission from the bankruptcy court for the abandonment of records complained about in the State Court Action. The Court finds that that action alone qualifies the then Trustee, Barbee, for judicial immunity.54

In dicta, the court seems to conclude that, if a trustee can be personally surcharged for negligence, the trustee is not entitled to any type of immunity. Immunity presumes the existence of otherwise actionable conduct; if negligence can be the basis for recovery, there is no room for immunity. The court here concludes that the trustee was not negligent. We believe that this is not the correct way to analyze judicial immunity and personal liability. First, it must be determined whether the trustee is entitled to immunity. If so, he cannot be sued in his personal capacity. If he is not entitled to immunity, then, and only then, should the court determine whether the trustee is personally liable using the appropriate standard of care test.

*In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1 (1st Cir. 1999) noted that, "Following *Mosser*, the courts of appeals have split almost evenly on the question of whether a

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54 *Id.* at 805.
bankruptcy trustee can be held personally liable for negligence (as opposed to deliberate misconduct).”\textsuperscript{55} The court partially overruled its earlier decision, \textit{In re San Juan Hotel Corp.}, 847 F.2d 931, 937 (1st Cir. 1988), which held trustees personally liable only for willful and deliberate violations. The court stated:

In our view, \textit{Mosser}, properly construed, strongly indicates that parties interested in the administration of a bankruptcy estate can seek to surcharge the trustee for negligence. While \textit{Mosser} itself involved "a willful and deliberate setting up of an interest in employees adverse to that of the trust," the Court took pains to clarify that "[t]he liability here is not created by a failure to detect defalcations, in which negligence might be required to surcharge the trustee...." 341 U.S. at 272, 71 S.Ct. 680. The unmistakable implication of this observation is that, in the absence of deliberate misconduct, negligence suffices for surcharge.\textsuperscript{56}

From there, the court turns to a discussion of trustee immunity, at page 8 as follows:

Following \textit{Mosser}, this court has explained that a trustee acting with the explicit approval of a bankruptcy court is entitled to absolute immunity, as long as there has been full and frank disclosure to creditors and the court. \textit{See, Lopez-Stubbe}, 847 F.2d at 942 (citing \textit{Mosser}, 341 U.S. at 274, 71 S.Ct. 680). This view has found near-universal favor elsewhere... \textit{See, e.g., Yadkin Valley}, 819 F.2d at 76; \textit{Lonneker Farms, Inc. v. Klobucher}, 804 F.2d 1096, 1097 (9th Cir. 1986); \textit{Boullion v. McClanahan}, 639 F.2d 213, 214 (5th Cir. Unit A Mar. 1981) (per curiam). Only if a trustee prevaricates or otherwise acts in bad faith does he doff the cloak of derived judicial immunity. \textit{See, Kowalski-Schmidt}, 212 B.R. at 624 ...

We believe that derived judicial immunity in this context is essential to the orderly administration of bankruptcy proceedings. Allowing suits against trustees for executing explicit court orders would run an unacceptably high risk of turning trustees into "lightning rod[s] for harassing litigation aimed at judicial orders" and would create counterproductive tension between bankruptcy judges and trustees.

\textsuperscript{55} \textit{Id.} at 7.

\textsuperscript{56} \textit{Id.} at 18.
Here, the court is admittedly confused. In this case, a chapter 11 creditor sought for leave to file suit against the chapter 11 trustee. Within the proposed complaint, the creditor alleged that the trustee failed to exercise her business judgment in a reasonable fashion when she initially refused to accept offers for sale of the ground leases and personal property of the debtor, failed to seek to set aside orders allowing assumption of the leases on the grounds that they were obtained without notice to creditors, did not employ a real estate broker to pursue offers, failed to undertake diligent marketing efforts, and further delayed sale because the trustee alleged a $2.5 million offer for certain property that the creditor alleged was not credible. The proposed complaint also asserted a claim for relief against the trustee’s counsel for legal malpractice and four claims against the trustee and her law firm: negligence, gross negligence, breach of fiduciary duty, and statutory duty.

The court goes into a discussion on trustee liability. The court suggests that, if in a position to craft an appropriate policy for trustee liability, the court would suggest that a trustee is entitled to immunity except for acts of gross negligence or willful and intentional acts. We believe that what the court should have said was that there should be no personal liability except for acts of gross negligence or willful and intentional acts. Whether the trustee acted with gross negligence would be irrelevant to the question of immunity where the trustee was acting pursuant to a court order.

The court goes on to discuss the Cochise Park case and opines that the standard in Cochise Park is actually gross negligence rather than simple negligence. The court then holds that no court order is needed for the trustee to invoke judicial immunity concerning sale negotiations or similar activities. Immunity should only apply where the trustee is acting pursuant to a court order or when the court delegates the trustee to perform a judicial function. After having determined that the trustee is not immune from suit, the court should have analyzed the allegations contained within the complaint. A description of the claims asserted within the complaint make it clear that the actions complained of were made by the trustee within the scope of his/her duty as trustee. Personal liability should not attach to the trustee pursuant to the business judgment rule and there does not appear to be any claims of intentional or gross misconduct that would warrant imposition of personal liability.

VI. THE BARTON DOCTRINE

A landmark decision in the Sixth Circuit Court of Appeals reaffirmed the common law rule, that leave to sue trustees not conducting business must first be obtained from the court appointing them.57 This rule is known as "the Barton Doctrine". The court in In re DeLorean Motor Company,58 stated as follows:

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It is well settled that leave of the appointing forum must be obtained by any party wishing to institute an action in a nonappointing forum against a trustee, for acts done in the trustee's official capacity and within the trustee's authority as an officer of the court...

A suit therefore, brought without leave to recover judgment against a receiver for a money demand, is virtually a suit the purpose of which is, and effect of which may be, to take the property of the trust from his hands and apply it to the payment of the plaintiff's claim, without regard to the rights of other creditors or the orders of the court which is administering the trust property. We think, therefore, that it is immaterial whether the suit is brought against him to recover specific property or to obtain judgment for a money demand. In either case leave should be first obtained.

The court also ruled (i) that the trustee was entitled to recover actual damages including costs, attorneys' fees and other administrative expenses, if any, by way of indemnification and (ii) that the trustee was entitled to a Section 105(a) injunction against a state court action.

_In re Mailman Steam Carpet Cleaning Corp.,_ 196 F.3d 1 (1st Cir. 1999) also discussed the Barton Doctrine. In this case, the Chapter 7 trustee sought and received court approval to abandon certain property of a bankruptcy estate. A creditor filed an adversary proceeding against the trustee, alleging negligence and breach of fiduciary duty. The court stated that, "Congress enacted Section 959(a) to carve out an exception to the Barton rule, not to expand the leave requirement to a new category of cases."

_In re Solar Financial Services, Inc._ has further clarified the meaning of the Barton Doctrine by citing an Eleventh Circuit case, _Carter v. Rodgers_, 220 F.3d 1249 (11th Cir. 2000) which stated, "[a]n unbroken line of cases ... has imposed [this] requirement as a matter of federal common law", and noting (albeit in a footnote) that the fact that a motion was filed against the trustee as opposed to a complaint commencing a lawsuit, is a distinction without a difference; the policy behind the leave of court requirement remains applicable.

_In re Campbell_, 13 B.R. 974 (Bankr. D. Idaho 1981)) (Emphasis added). The DeLorean decision also extended the Barton Doctrine to trustee's counsel as the "functional equivalent of a trustee, where as here, they act at the direction of the trustee, where as here, they act at the direction of the trustee and for the purpose of administering the estate or protecting its assets". _Id._


60 _In re Mailman Steam Carpet Cleaning Corp._, 196 F.3d at 5. See also, _In re J.F.D. Enterprises, Inc._, 223 B.R. 610 (Bankr. D. Mass. 1998).


62 _Id._ at 804.
Moreover, *In re Kids Creek Partners, L.P.*, 248 B.R. 554 (Bankr. N.D. Ill. 2000) has removed another argument from the arsenal of litigators who wish to file suits against trustees. When plaintiffs failed to petition the court for leave to sue the trustee prior to filing their pending suit, because their counsel explained that they risked the tolling of applicable statutes of limitations, the court stated that this reasoning "hardly justifies failure to apply here first in time for consideration before the tolling." As important the court also ruled, "Failure to follow the prescribed procedure requiring advance permission is itself grounds to deny the present motion." The case also quoted, *In re Linton*, which held that a former debtor and husband had to obtain leave of the bankruptcy court before filing a state court action against the trustee stating:

If debtors, creditors, defendants in adversary proceedings, and other parties to a bankruptcy proceeding could sue the trustee in state court for damages arising out of the conduct of the proceeding, that court would have the practical power to turn bankruptcy losers into bankruptcy winners, and vice versa. A creditor who had gotten nothing in the bankruptcy proceeding might sue the trustee for negligence in failing to maximize the assets available to creditors, or to the particular creditor. A debtor who had failed to obtain a discharge might through a suit against the trustee obtain the funds necessary to pay the debt that had not been discharged.

Finally, the United States Bankruptcy Appellate Panel of the Ninth Circuit extended the Barton Doctrine when it ruled, "...that leave to sue the trustee is required to sue in those federal courts other than the bankruptcy court which actually approves the trustee's appointment." This court also concluded earlier in the case the more well known principle of common law, that leave must be obtained to sue a trustee in the state court as well. Both principles have been very recently upheld in the Eleventh Circuit Court of Appeals, *Carter v. Rodgers*, 220 F.3d 1249 (11th Cir. 2000). This case presented an issue of first impression in that circuit regarding whether a plaintiff (in this instance, a debtor) must first obtain leave from the bankruptcy court before it can initiate an action against the trustee in the district court. The court held that a debtor must obtain leave of the bankruptcy court before initiating an action in district court stating, "We find no reason to distinguish between instances where the trustee is sued in state
court and those in which the trustee is sued in federal court.\textsuperscript{68}

However, a minority opinion in the Ninth Circuit Court of Appeals casts some doubt on the universal application of the Barton Doctrine stating:

\begin{quote}
The majority disposition may be correct. I find, however, no authority dictating its conclusion, nor, I should add, any compelling the opposite result. Case law simply does not answer the question whether a third-party, whose property is seized by a trustee acting pursuant to an authorization to seize the property of the bankrupt estate, may simply proceed to sue in tort in state court or whether he must first ask the bankruptcy court to return his wrongfully seized property or give him permission to sue elsewhere.\textsuperscript{69}
\end{quote}

\textit{Muratore v. Darr}, 375 F.3d 140 (1\textsuperscript{st} Cir. 2004)

Approximately two years after the bankruptcy court closed the case, Chapter 11 debtor brought an action against the trustee in federal district court. For reasons unrelated to the suit, the bankruptcy court reopened the bankruptcy proceedings. The case was still open when the debtor amended his complaint to allege that the trustee “did not faithfully perform the duties of his office and committed acts of misfeasance [and/or] malfeasance in the performance of his duties in that…” trustee (1) did not pay the taxes due, and debtor lost six properties at a tax sale; (2) defectively sold at foreclosure rental and income properties, which generated six law suits; (3) failed to file corporate returns, resulting in the forfeiture of the corporation’s charter and causing real estate to revert to the corporate stockholders; (4) failed to file tax returns, resulting in the denial of the issuance of letters of good standing, causing defective titles and defeating transfer of titles; and (6) that the purchases of some properties were procured with funds from the Gambino family in violation of federal law.

Debtor alleged that the trustee’s gross negligence caused it to be put out of business rather than placed in a position to reorganize. Debtor did not obtain leave of the bankruptcy court or seek bankruptcy court authority before filing the suit. The trustee then moved to dismiss the case for lack of subject-matter jurisdiction. The district court granted the motion and Debtor appealed.

The question on appeal was whether the Barton doctrine bars the bringing of an action in federal District Court against a bankruptcy trustee without the prior permission of the Bankruptcy Court. Debtor argued that section 959(a) applied because the claims applied to the trustee’s “acts or transactions in carrying on business connected with” the bankruptcy estate.

In considering Debtor’s argument, the First Circuit noted that some courts have

\begin{flushright}
\textsuperscript{68} \textit{Id.} at 2.
\end{flushright}
interpreted this phrase to mean acts or transactions in conducting the debtor's business in the ordinary sense of the words or in pursuing that business as an operating enterprise. *See, e.g.*, *Melvin v. Klein*, 49 Misc. 2d 24, 266 N.Y.S.2d 533, 536-37 (Sup 1965). Further, in interpreting section 959(a)'s predecessor, 28 U.S.C.A. § 125, the Second Circuit had concluded that "merely to hold matters in status quo; to mark time, as it were; to do only what is necessary to hold the assets intact; such activities" did not constitute carrying on business. *Vass v. Conron Bros. Co.*, 59 F.2d 969, 971 (C.C.A. 2d Cir. 1932). In *Carter v. Rodgers*, 220 F.3d 1249, 1254, 36 Bankr. Ct. Dec. (CRR) 138, 44 Collier Bankr. Cas. 2d (MB) 943 (11th Cir. 2000), however, the Eleventh Circuit held that section 959(a) was intended to "permit actions redressing torts committed in furtherance of the debtor's business, such as the common situation of a negligence claim in a slip and fall case where a bankruptcy trustee, for example, conducted a retail store." Section 959(a) has been applied where a trustee continued the business of a debtor in operating a railroad, and the trustee had been sued in his representative capacity for damages for use of another's tracks. *Thompson v. Texas Mexican Ry. Co.*, 328 U.S. 134, 138, 66 S. Ct. 937, 90 L. Ed. 1132 (1946). Also, the exception has been held to apply to an employee's claims arising from injuries caused by overwork at a railroad company operated by the trustee and the trustee's withholding of an employee's pension. *Haberern v. Lehigh & N. E. Ry. Co.*, 554 F.2d 581, 585 (3d Cir. 1977). On the other hand, courts have concluded that merely holding and collecting the assets intact, collecting and liquidating the assets of the debtor, and taking steps for the care and preservation of the estate do not constitute carrying on business. Likewise, actions taken in the mere continuous administration of property under order of the court do not constitute an act or transaction in carrying on business connected with the estate. See *Field v. Kansas City Refining Co.*, 9 F.2d 213, 216 (C.C.A. 8th Cir. 1925); see also *In re DeLorean Motor Co.*, 991 F.2d 1236, 1241, Bankr. L. Rep. (CCH) P 75259 (6th Cir. 1993) [Norton Bankr. L. & Prac. 2d § 79:14].

The First Circuit agreed with the District Court that section 959(a) did not apply to these facts. The allegations in the complaint focused upon the trustee's actions in the fulfillment or non-fulfillment of his fiduciary responsibilities as trustee, as opposed to acts or transactions in the furtherance of debtor's business. The accounting for and sale of property, the filing of tax returns, and the payment of taxes, which the trustee was alleged to have failed to do, were among the trustee's statutory responsibilities and powers as a Chapter 11 trustee. Debtor did not appear to dispute that the trustee had these responsibilities; rather, he argued that the trustee did not adequately respond to them—specifically, that he did not liquidate properties quickly enough, improperly liquidated properties, and did not pay taxes or file tax returns. The different counts in debtor's complaint all alleged the trustee's misconduct in discharging his trustee's administrative responsibilities. *See, e.g.*, *Austrian v. Williams*, 216 F.2d 278, 285 (2d Cir. 1954) (holding in Chapter 11 case that section 959(a) did not apply and stating that merely to attempt to collect and liquidate the assets of a debtor is not to carry on its business in any proper sense of the term.) Since debtor based his complaint on the trustee's alleged misconduct in liquidating and administering the estate's property, and not on tortious acts committed in the furtherance of debtor's leasing or mortgage and real estate business, section 959(a) did not apply.

The Court then went on to reject debtor's further argument that urged the Court to recognize as an additional or expanded exception to the Barton doctrine the situation where the trustee commits a tort of any sort. It specifically rejected the reasoning of *Matter of Campbell*, 13 B.R. 974, 976 (Bankr. D. Idaho 1981) where the Bankruptcy Court appeared to recognize two
situations in which a trustee may be sued without leave of the federal Bankruptcy Court, one being where the trustee has committed a tort, and the other where the claim of wrongful doing arises out of the trustee's operating of the debtor's business. The First Circuit found this decision to be the only example of a court having articulated so broad an exception to the Barton doctrine and itself found no basis for recognizing some generalized tort exception to the Barton doctrine.

The Court also rejected the argument that the Barton doctrine did not apply here because the bankruptcy case was closed. To be sure, one purpose of the Barton doctrine is to prevent a party from obtaining some advantage over the other claimants upon the assets in the trustee's hands and that purpose would not necessarily be served here. But the doctrine serves additional purposes even after the bankruptcy case has been closed and the assets are no longer in the trustee's hands, and numerous cases have so held.70

In Hearvin v. J. Baxter (In re Triple S Restaurants, Inc.), 342 B.R. 508 (Bankr.W.D.Ky. 2006), the bankruptcy court held that the suit filed a recipient of an avoided transfer against the bankruptcy trustee was subject to dismissal for failure to obtain leave of court prior to filing suit. The chapter 7 trustee allegedly threatened to report the plaintiff to the United States attorney’s office for criminal prosecution if he did not pay the approximate $252,000 judgment rendered against him. The plaintiff failed to pay the debt and the trustee did, in fact, report the plaintiff to the United States attorney’s office, which caused four indictments to be returned against the plaintiff. The plaintiff then filed suit in state court against the trustee, alleging that the trustee engaged in “actionable, outrage/intentional infliction of emotional distress” in issuing and later following up on the threats. The bankruptcy court found that the suit should be dismissed because the plaintiff failed to obtain leave of the bankruptcy court. Further, the court found that the trustee was protected by quasi-judicial immunity, as he was acting within the scope of his authority when he attempted to collect the judgment for the benefit of the bankruptcy estate. Finally, the court found that, regardless, the claims asserted against the trustee (10 years after the alleged occurrence) were clearly barred by the statute of limitations. The bankruptcy court found that it was clear that the plaintiff had filed the action as a way to retaliate against the trustee, who was a star witness in the criminal case against the plaintiff. Thus, the court found that sanctions were warranted and ordered the plaintiff to pay all court costs and attorney fees incurred by the trustee.

A. DOES BARTON APPLY IN SUITS AGAINST LIQUIDATING TRUSTEES?

In re Crown Vantage, Inc., 421 F.3d 963 (9th Cir. 2005).

In this case the Ninth Circuit, held that pursuant to the Barton doctrine, leave of the bankruptcy court must be obtained before a party initiates an action in another forum against a bankruptcy trustee or officer appointed by the bankruptcy courts for acts done in the officer’s official capacity. The fact that the officer being sued was a liquidating trustee rather than a

70 2004 No. 9 Bankruptcy Service Current Awareness Alert 3, First Circuit, following numerous precedents, rules that a plaintiff must obtain Bankruptcy Court approval before commencing an action against a trustee based on negligence or malfeasance in administering the estate
bankruptcy trustee was of no moment.

*In re WRT Energy Corp.*, 2007 WL 2893426 (Bankr. W.D. La.)

Is the Barton doctrine viable in the Fifth Circuit? If so, is the Barton doctrine applicable to the trustee of a liquidating trust? Does the bankruptcy court have post-confirmation jurisdiction over a liquidating trust?

In 1997, the bankruptcy court confirmed a chapter 11 plan which provided for the creation of a “Liquidation Entity” as a representative of the debtor’s estate for the purpose of pursuing potential causes of action. The confirmed chapter 11 plan also provided for the execution of a “Trust Agreement.” Although the confirmation order did not appoint a trustee of the liquidation entity, the trust agreement named a trustee. Over the next few years, the trustee of the liquidation entity brought multiple claims against various parties. Eventually, the trustee collected over $17 million through its activities. However, the liquidating entity only produced a net return of $19,000 after costs and expenses were offset. Consequently, several trust beneficiaries filed a complaint in the United States District Court, Western District of Texas, alleging multiple causes of action, including breach of fiduciary duty, breach of contract, and gross negligence. The trustee objected in the bankruptcy court arguing that the trust beneficiaries did not seek court approval pursuant to the Barton doctrine.

The Barton doctrine provides that a court appointed trustee cannot be sued for actions taken in the trustee’s official capacity unless leave if first obtained from the court that appointed the trustee. The beneficiaries first argued that the Fifth Circuit has never expressly adopted the Barton doctrine. The bankruptcy court disagreed. The bankruptcy court noted that while the Fifth Circuit itself has never expressly applied Barton, lower courts in the circuit have recognized and applied the doctrine to bankruptcy trustees. Accordingly, the bankruptcy court recognized the viability of the Barton doctrine in the Fifth Circuit.

The bankruptcy court also concluded that the Barton doctrine applies to liquidating trustees. The bankruptcy court was persuaded by In re Crown Vantage, Inc., in which the Ninth Circuit reasoned that the Barton doctrine applies to liquidating trustees who represent the estate because they are the functional equivalent of a trustee appointed under the Code. Thus, the bankruptcy court held that the Barton doctrine applied to the trustee of the liquidating entity.

However, the bankruptcy court ultimately concluded that it did not have post-confirmation jurisdiction over the claims against the trustee. According to the bankruptcy court, the claims against the trustee did not have the requisite nexus to the chapter 11 plan so as to justify post-confirmation jurisdiction because the plan had been substantially consummated, confirmed over 10 years earlier, and the trust terminated in 2000. Moreover, the claims against the trustee arose post-confirmation. Thus, without subject matter jurisdiction, the bankruptcy court could not apply the Barton doctrine.

**VII. TRUSTEE BONDS: LIABILITY OF SURETY**

11 U.S.C. § 322, entitled “Qualification of Trustee” provides:
(a) Except as provided in subsection (b)(1), a person selected under section 701, 702, 703, 1104, 1163, 1202, or 1302 of this title to serve as trustee in a case under this title qualifies if before five days after such selection, and before beginning official duties, such person has filed with the court a bond in favor of the United States conditioned on the faithful performance of such official duties.

(b)(1) The United States trustee qualifies wherever such trustee serves as trustee in a case under this title.

(2) The United States trustee shall determine--

   (A) the amount of a bond required to be filed under subsection (a) of this section; and

   (B) the sufficiency of the surety on such bond.

(c) A trustee is not liable personally or on such trustee's bond in favor of the United States for any penalty or forfeiture incurred by the debtor.

(d) A proceeding on a trustee's bond may not be commenced after two years after the date on which such trustee was discharged.

Question: if trustee is entitled to quasi-judicial immunity and therefore, not liable for his negligent acts, is the surety liable on the bond?

**U.S. v. Perkins, 280 F. 546 (8th Cir. 1922)**

Sureties on official bonds are liable for negligence or malfeasance of their principal in the performance of acts which are done virtue officii. The bond providing only for the faithful discharge of the principal of his official duties, the condition of the bond is considered to have been broken by the mere negligence, without corruption, of the principal in the performance of a ministerial duty, which performance does involve the exercise of discretion, and, where the duty which has not been faithfully discharged was owing to the person injured, such person may sue on the bond. By the weight of authority, acts done by color of office are regarded as acts for which sureties on official are liable. 29 Cyc. 1455, 1456, and cases cited. The acts here complained of fall within this category, and particularly so in view of the charge that they were done with wrongful intent and purpose.


As exercise of ordinary care in making and maintaining deposits, even if made in designated depository, was part of trustee's official duty, trustee's surety is liable on bond if trustee failed in this respect.

Later-filed, additional court fiduciary bonds under 11 USCA § 322 cover prior defalcations in 2 circumstances: (1) where trustee, while solvent, breaches continuing duty to recover assets during term of later-filed bond; or (2) where trustee breaches his duty to account for and pay over assets of bankruptcy estate during term of later-filed bond; damages flowing from these breaches, failure to recover assets, and failure to account and pay over estate assets encompass losses due to misappropriation or defalcations even if committed prior to bonds' issuance.


Surety for Chapter 7 trustee is liable on bond under 11 USCA § 322 where trustee is found negligent in execution of his duties for failing to preserve asset of estate.


The bankruptcy court held that, because the statute of limitations on the action against the trustee personally had run prior to the commencement of the action on the bond, plaintiff could not hold the bond company liable, despite the fact that the limitations period for an action upon the bond under section 322(d) may not yet have run. Citing with approval the passage from the bankruptcy court decision in In re Oles Grain, 206 B.R. 126 (Bankr. N.D. Tex. 1997):

[T]he liability of a surety is derivative in nature, and depends on the principal's liability. Since the present action against the bonding company is filed on the basis of the trustee's negligence, then the bonding company should have the benefit of the statute of limitations for that cause of action. If the statute of limitations has run against the trustee, then the statute also acts as a bar for suits against the trustee's bonding company.

Oles Grain, 206 B.R. at 132-33.

Since § 322(d) does not address whether a surety can be discharged by the running of the limitations period for an underlying cause of action against the trustee, courts may turn to state law to fill in this particular gap of an unquestionably federal cause of action, Louis Rosenberg Auto Parts, 209 B.R. 668, citing 19 Wright, Miller & Cooper, supra §§ 4516, 4518 (2d ed.1996). The bankruptcy court noted that, according to Pennsylvania state law, a surety is not discharged although a principal may have been previously discharged by the running of the limitations period in an action directly against it. The court, however, decided not to “mechanically” look to Pennsylvania state law in this particular instance.

As an initial matter, this Court points out that, although courts, when filling in the gaps of a reasonably detailed federal statutory scheme, quite often look to and borrow from the rules of a forum state, they are not necessarily bound to do so. 19 Wright, Miller & Cooper, supra §§ 4516, 4518. Therefore, if a court ascertains strong reasons for departing from the rules of a forum state, it may disregard said rules and adopt as federal common law those of another
This Court ascertains strong reasons in this particular matter for departing from the law in Pennsylvania and holding that a surety can be discharged from liability on a bankruptcy trustee's bond if the pertinent limitations period for an underlying cause of action against said trustee has run prior to the commencement of an action upon said bond.

“[T]o allow a party to proceed against a surety bond after a limitations period has already passed on an action directly against the principal, would permit said party to essentially circumvent said limitations period and, thereby, render it ineffective; such a situation appears to be antithetical to the intent of the limitations period on the underlying action against a principal.”

However, the decision relied upon, Oles Grain, was later vacated on appeal by the Texas district court. The district court ruled that Texas law, which stated that sureties are not automatically exonerated from liability on bond whenever a suit against their principals would be untimely would be applied. “[I]n determining state law, this Court bound to apply only ‘the law as interpreted by the state's highest court.’” Oles Grain, 221 B.R. 371 (N.D.Tex. 1998), citing Ladue v. Chevron, U.S.A., Inc., 920 F.2d 272, 274 (5th Cir.1991). In determining state law, federal district court is bound to apply only state law as interpreted by state's highest court, and is not bound by decisions of intermediate state appellate courts. It appears then, at least within the Fifth Circuit, that state law must be applied in determining whether a surety is liable on the bond even if the principal is exonerated. If the surety continues to be liable, at least with respect to trustee bonds, the principal is bound to reimburse the surety. Further, not only is state law applicable, but individuals must also look to the language of the bond to determine the extent of the liability of the surety.

VIII. CLERK OF COURT LIABILITY

Actions seeking to impose liability on clerks of court generally arise in the context of alleged violations of civil rights.71 Most courts extend absolute immunity, a form of quasi-judicial immunity, to clerks for performing functions incident to their duties as clerks. In some instances, however, courts have not extended absolute immunity to clerks, but rather, have allowed a clerk to claim qualified immunity. The following cases illustrate the immunity clerks of court enjoy from civil prosecution for allegedly harmful acts.

Mullis v. United States Bankr. Court, 828 F.2d 1385 (9th Cir. 1987)

In Mullis, the plaintiff intended to file bankruptcy. He apparently prepared his own

petition and sent his wife to the bankruptcy court to file the petition. He directed his wife to ask the deputy clerk which chapter of the bankruptcy code would allow him to withdraw, or dismiss, his petition as a matter of right. Therefore, the plaintiff did not designate under which chapter he intended to file. The plaintiff alleged that the clerks neither gave his wife the information nor told her that they could not give legal advice. Instead, the clerk assured plaintiff’s wife that the petition would be filed under the appropriate chapter of the bankruptcy code. The deputy clerk accepted the petition and filed it under Chapter 7 of the bankruptcy code. Later the clerk’s office refused to accept an amended petition on the ground that the chapter designated on the petition was incorrect.

The plaintiff then attempted to withdraw his petition and dismiss his bankruptcy case. The bankruptcy court denied his motion. After a long battle attempting to appeal the bankruptcy judge’s ruling, the plaintiff brought the instant action against the bankruptcy judges and the bankruptcy court clerk’s office. The plaintiff alleged that the court clerks violated his civil rights by failing to give proper counseling and notice regarding chapters under which the plaintiff could file; accepting an incomplete petition under Chapter 7; and refusing to accept an amended petition.

The Ninth Circuit affirmed the lower courts dismissal of the plaintiff’s claims against the court clerks. The Ninth Circuit stated that court clerks have absolute quasi-judicial immunity from damages for civil rights violations when they perform tasks that are an integral part of the judicial process. The Court found that even if the plaintiff’s allegations were true, all the acts complained of could be characterized as “integral parts of the judicial process.” All the acts alleged involved the filing of a petition, which is done through the clerk of court. The clerks did not act in a clear absence of all jurisdiction, and therefore, the clerks were entitled to absolute judicial immunity.72

It is interesting to note that in Mullis, the Ninth Circuit extended absolute immunity to clerks of court for performing functions “integral to the judicial process.” The actions of which the plaintiff complained in Mullis were mundane, routine tasks involving the filing of a petition. For these tasks, absolute immunity was appropriate. Mullis, however, is a pre-Antoine case, and therefore, does not discuss whether a discretionary distinction should be made in the dispensation of absolute versus qualified immunity. Some of the acts alleged by the plaintiff in Mullis to be harmful arguably did contain an element of judicial discretion – deciding which chapter the petition should be filed under, refusal to accept an amended petition. For these acts, absolute immunity is arguably available.

However, more recently, Mullis has been cited for the blanket proposition that clerks are entitled to absolute immunity, without regard to an investigation of whether the acts causing harm were discretionary.73 In this regard, it is interesting that the Bankruptcy Appellate Panel in

72 The grant of absolute quasi-judicial immunity to clerks is still valid in the Ninth Circuit. See, Cross v. Third Appellate District Court, 161 F.3d 12 (Table) (9th Cir. 1998). See also, Rogers v. Bruntrager, 841 F.2d 853 (8th Cir. 1988); Scruggs v. Moellering, 870 F.2d 376 (7th Cir.1989).

73 See, Cross v. C.D. Cal., 208 F.3d 220 (9th Cir. 2000).
Castillo chose not to extend absolute immunity to a trustee for failing to provide notice of a hearing (a function also done by clerks of court in some instances). Given Antoine’s focus on discretion, Castillo may very well be right on the issue of absolute immunity, however, it does seem odd that courts within the Ninth Circuit would provide absolute immunity to clerks of court, but not to trustees for the performance of acts identical in nature to those to which a clerk of court would be absolutely immune.

The next two cases, although also pre-Antoine, illustrate the role of discretion incident to an extension of absolute liability to clerks of court.

**McCray v. Maryland, 456 F.2d 1 (4th Cir. 1972)**

In McCray, a prisoner sued a clerk of court alleging that the clerks negligence prevented the prisoner from filing for post-conviction relief. The district court dismissed the suit finding that clerks of court are quasi-judicial officers cloaked with absolute immunity. The Fourth Circuit reversed. In the view of the Fourth Circuit, immunity of “quasi-judicial” officers stems not necessarily from their formal association with the judicial process, but from the fact that they exercise a discretion similar to that exercised by judges. Where an official is not called upon to exercise judicial or quasi-judicial discretion, an extension of absolute judicial immunity is unwarranted.

In this case, the Fourth Circuit found that the clerks duties, with respect to the filing of papers with the court, are mandatory and ministerial. The act of filing papers requires no discretion that merited insulation of liability by a grant of absolute immunity. Therefore, the clerks were not absolutely immune. Interestingly, the court did not discuss whether the clerks were entitled to qualified immunity. The reversal was based solely on a finding that absolute immunity was unwarranted.

**Williams v. Wood, 612 F.2d 982 (5th Cir. 1980)**

The Fifth Circuit followed suit with the Fourth Circuit’s McCray decision. However, the Fifth Circuit has extended the analysis to include the potential for qualified immunity for damages caused by a wrongful act on the part of a court clerk.

In Williams, after the district court denied the plaintiff’s motion to alter or amend an adverse judgment issued against him, the plaintiff sought to appeal the denial of the motion. The appeal was dismissed, however, because the plaintiff failed to timely file a notice of appeal. The plaintiff instituted the instant suit against the clerk of court alleging that the clerk maliciously failed to give notice of the denial of the plaintiff’s motion in time for the plaintiff to file a timely notice of appeal. According to the plaintiff’s allegations, he did not receive a copy of the order dismissing the motion, and later called the clerk’s office. During this call, the clerk’s office allegedly informed him that the court had not made a determination in the case, and that the clerk’s office could not locate the file. The clerk who handled the call also allegedly told the

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74 The case is not very clear as to what acts on the part of the clerk prevented the prisoner from petitioning for post-conviction relief.
plaintiff that the clerk would call him and advise when the order was entered. The district court dismissed finding that the clerks were entitled to absolute judicial immunity.

The Fifth Circuit, however, reversed. According to the Fifth Circuit, a clerk of court performing routine duties such as entering an order and notifying does not enjoy absolute immunity from damages caused by that conduct. Instead, the clerk enjoys qualified immunity. However, a clerk performing discretionary acts or acts at the behest or order of a judge is entitled to absolute immunity. In this case, the act (or non-act) was the failure to notify the plaintiff. As such, it was non-discretionary, and therefore, absolute immunity did not apply. Because the plaintiff alleged that the clerk acted with malice and in bad faith, those allegations, if true, would overcome the defense of qualified immunity. Thus, dismissal was improper.
ATTORNEY SOLICITATIONS FOR COMMITTEE REPRESENTATION – WHAT RULES APPLY?

by Brett D. Fallon and Douglas N. Candeub, Morris James LLP, Wilmington, Delaware

Attorneys’ solicitations for engagement by a prospective creditors’ committee raise a host of legal and ethical questions – and many of them don’t have a clear answer. That counts as bad news if you think the rules should clearly delineate what is within bounds and what is out of bounds. On the other hand, it counts as good news if you infer from the near absence of court decisions on improper committee solicitations that no unethical behavior occurs during the solicitation process.¹ (Another possible inference: we’re all slackers, with the result that nothing gets brought to court).

It also counts as good news if you enjoy a lively debate at the Spring Business Law Section Meeting. Here is a starting hypothetical, with many variations.

Hypothetical 1: Hire Me And Get A Free Dinner! A Delaware company based in New Jersey files a Chapter 11 case in Delaware. A committee is to be formed. A New York attorney, John Smith, wants to gain the representation of the creditors’ committee. Having obtained the “top twenty” creditors’ list, he has his secretary send a letter to each of those creditors inviting them to a nice Thai dinner in Wilmington, Delaware, the night before the committee formation meeting. He had no prior relationship with any of the creditors; a third of the recipients of his letter were lawyers. On the outside of the envelope, in very small font, were the words: “Time-sensitive. This is not Advertising Material.” Half of them respond and come to the dinner. There, he openly asks of all who come, in the event they are placed on the creditors’ committee by the U.S. Trustee, to support employing him as the committee’s attorney.

Question 1: In Wilmington, can you really get Thai food? Where?

Question 2: Does buying a dinner for a potential committee member, with the hope of having he or she support your employment by the committee, violate Model Rule 7.2(b)?

Would your answer change if everyone who was there got ill from the food served, so that the “value” of the dinner would at best be a negative?

Question 3: Did the outside envelope of Smith’s letter satisfy Model Rule 7.3(c), since it did include the requisite words “Advertising Materials” (even though preceded by the word “not,” and in small font)? Alternatively, if he omitted words “Advertising Material,” could Smith defend against any assertion that he violated the rule by arguing that his letter did not “solicit professional employment” but rather only extended a dinner invitation? Or, could Smith rely on language in *Edenfield v. Fane*, 507 U.S. 761 (1993) to argue successfully that the Model Rules’ limitations on freedom of speech in this respect are overbroad as applied to communications to sophisticated business executives, unlikely to be unduly influenced by initial marketing materials? Could Smith successfully rely on a Supreme Court decision which held that an order banning communications with potential class members was inconsistent with Fed. R. Civ. P. 23, and any order restricting such communications must be made on a specific showing of abuses or potential abuses?

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3 Model Rule 7.3(c) requires that “Every written, recorded or electronic communication from the lawyer soliciting professional employment from a prospective client known to be in need of legal services in a particular matter shall include the words “Advertising Material” on the outside of the envelope . . . unless the recipient of the communication is a person specified in paragraphs (a)(1) or (a)(2)” [i.e., ones who are lawyers or ones with whom there was a prior relationship].

4 In *Edenfield*, the Supreme Court held unconstitutional Florida’s total ban on any direct, in-person or uninvited solicitations by certified public accountants to a person not already a client.

Question 4: If Smith is successful in gaining employment as counsel to the creditors’ committee, can he be reimbursed by the estate for the expense of the dinner?6

Hypo Variation 1: I’m Telling the Delaware State Bar About This! Suppose that Sally Jones, an attorney competing for employment by the creditors committee, learned of the dinner and brought Smith’s conduct to the attention of the Office of Disciplinary Counsel of the Supreme Court of Delaware.

Question 1: Does it matter that attorney Smith is from New York, a state that continues to have in force the Code of Professional Responsibility7, with its canons and disciplinary rules, rather than the Model Rules, which were adopted in Delaware? Would the Office of Disciplinary Counsel tell Jones to contact the New York bar’s equivalent body? Or would the Disciplinary Counsel have an interest in the matter because the dinner was held in Delaware, and it was for purposes of gaining representation in a Delaware case? For the Disciplinary Counsel to become involved, would Smith need to have had local counsel (i.e., from Delaware) with him at the dinner?

Question 2: What if, instead, Jones contacted the U.S. Trustee’s office to complain about Smith’s conduct and, in particular, the dinner solicitation? If the creditors committee did indeed select Smith to be its counsel, would the U.S. Trustee object to Smith’s application for employment on the basis of the dinner solicitation? Or would the U.S. Trustee regard the application of Model Rule 7.3 to be beyond its bailiwick, as long as Smith is a well-regarded, competent counsel who has no conflicts of interest with the debtor or other individual creditors?

Hypo Variation 2: Let’s Panic Creditors With Cold Calling! Suppose Smith does not send letters to the “top twenty” creditors. Instead, Smith tells Bob Field, a restructuring

7 See N.Y. Comp. Codes R. & Regs. tit. 22, § 1200.1, et seq.
consultant with whom Smith has frequently worked, that he is interested in seeking representation of the committee in the case. Field, who himself will be seeking employment by the creditors committee, places “cold call” phone calls to those creditors, and he patches Smith in on the calls, after reaching them. In the phone calls, Smith and the consultant describe the Chapter 11 process and what is known about the bankruptcy case, including that the creditors are at risk of “losing their shirts,” and inform the creditor representatives that they will be attending the committee formation to seek employment from the committee.

Question 1: If Smith is widely known in his community to be an altruist who is “always looking out for the other guy” and who places others’ interests above his own, can he successfully rebut a charge that a “significant motive” for his participation in the calls was his own pecuniary gain? Alternatively, if Smith is a salaried associate at a law firm that has no bonus structure, can he defend against the charge of being motivated by pecuniary gain because his firm, not he, would enjoy the gain from the employment?

Question 2: Is there ever a time when phone calls by Field then joined by Smith are permissible under the Rules? Theoretically, though perhaps not plausibly, the cooperation between Smith and Field could be unspoken, and uncoordinated in advance. Or, Field could place the first call by himself, and request permission to call back a second time, and mention that Smith would be on the call. Or, perhaps the content of the conversation could be tailored to

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8 Model Rule 7.3(a) provides that a “lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer’s doing so is the lawyer’s pecuniary gain, unless the person contacted (1) is a lawyer; or (2) has a family, close personal, or prior professional relationship with the lawyer.”

9 Model Rule 8.4(a) makes it “professional misconduct” for a lawyer to “violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another.”
stop short of a request for the creditor’s support, and vote, at the committee formation meeting. It is unclear whether these or other distinctions would make a difference.¹⁰

Hypo Variation 3: At Least I’ll Get One Client Out of This! Suppose that Smith fails in his attempt to gain employment by the creditors committee. Nevertheless, one of the ‘top twenty’ creditors decides to hire Smith to represent its individual creditor interests.

Question 1: It has been suggested that the solicitation made of individual creditors, who have not yet been selected for placement on an as-yet unformed creditors committee, cannot violate the ethical rules on solicitation of prospective clients, because at the time of the solicitation, the committee does not yet exist and its membership is not yet known. It has also been suggested that such a reading Rule 7.3(a), being “based on a literalist reading of the rule[,] would appear to be evasive.”¹¹ But assuming for argument’s sake that the advance solicitation of committee members for employment by a not-yet-formed committee passes muster, would Smith’s dinner solicitation still violate the Rule because it could be an indirect solicitation of representation of any of those creditors individually? Would it matter whether Smith’s intent was only to solicit business from the prospective creditors committee, and not to seek the representation of any individual creditors?

Question 2: If Smith was unsuccessful in his effort to be employed by the creditors committee the following day, and was not thereafter employed by any of the “top twenty” creditors, would anyone still care about his conduct at the dinner?

¹⁰ The Model Rule treats telephone and in-person solicitations the same way. In-person solicitations would appear to encompass lawyers “working the room” at the committee formation meeting, before the meeting starts. There, lawyers routinely introduce themselves to, and schmooze with, the creditors in attendance who may be selected to join the committee, in the hope that the creditors will later choose them to represent the committee. One practitioner has suggested that “working the room” is “probably forbidden” under the Model Rules, but that nevertheless, no one is going to cease working the room at committee organizational meetings. Richman, “Chasing Committees”, 22 Oct. Am. Bankr. Inst. J. at 58.

Conclusion. Much is at stake in gaining the representations of creditors committees in bankruptcy cases. With official guidance so limited as to the application of generally applicable rules of professional conduct to the somewhat unique situation of committee representations, it is not surprising that bankruptcy practitioners have developed a range of interpretations concerning what types of solicitation-related conduct are permissible. Come listen to a discussion of how the general principles should be applied.

On April 12, 2008, at the Spring Meeting, the Subcommittee on Bankruptcy Committees and the Subcommittee on Professional Ethics in Bankruptcy will jointly present a program on the topic “Getting the Work And Avoiding the Sanctions – Ethical Issues in Soliciting for Committee Representation.” Roberta DeAngelis, Acting General Counsel, Executive Office of the United States Trustee, Washington, D.C.; Gerald M. Gordon, Partner, Gordon & Silver Ltd., Las Vegas, Nevada; David B. Stratton, Partner, Pepper Hamilton LLP, Wilmington, Delaware and Kaaran Thomas, Counsel, McDonald Carano LLC, Reno, Nevada will speak, moderated by Professor Nancy Rapoport of William S. Boyd School of Law, UNLV, Las Vegas, Nevada.

The program will be held in the Opal Room, Tower, Lobby Level, at the Hilton Anatole Hotel. Come out and watch the fun.
SELLING BANKRUPTCY CLAIMS: GETTING IN ON CASHING OUT

by Christopher Combest, Quarles & Brady LLP, Chicago, Illinois

Many businesses view claims against customers in bankruptcy more as liabilities than as assets: entitlements of uncertain value to be paid, if at all, in an indefinite number of installments over an unknown period of time.

However, many investment firms do treat bankruptcy claims as assets, for which they are willing to pay cash. "Vulture funds" purchase millions – even billions – of dollars in bankruptcy claims from creditors at a portion of their face value, in anticipation of influencing the outcome of the bankruptcy case or of a higher distribution – in cash or in equity of the reorganized debtor – at the end of the case. While such funds seek to leave as much risk as possible with the creditor-seller, they are often willing to negotiate on several issues. Here are some important points to consider and watch for:

**Don’t Be Afraid to Shop Around:** If one purchaser wants to buy your claim, chances are that several others are also in the market. You may receive multiple cold calls and at any time (even late in a case, after a debtor has begun making distributions on your claim); your industry colleagues, your financial advisors, and your lawyer may also know of opportunities for the sale of a bankruptcy claim.

**Exactly What Is the Buyer Offering to Buy?:** Claim purchasers typically limit their risk by offering to purchase, up front, only those claims that are least likely to be challenged by the debtor. While creditors are often owed more than the debtor acknowledges in the schedules of liabilities filed with the court, claim buyers will usually pay immediately only for a claim that is listed as undisputed in those schedules or that has been allowed (*i.e.*, recognized as valid) by court order. Purchase agreements often provide that, if a purchased claim of one amount is later
allowed in a higher amount, the buyer may, at its option, purchase that excess amount at the same percentage rate it paid for the initial amount.

**When Does the Buyer Pay?:** Oddly, most purchase agreements omit one important provision: a date certain by which the buyer must pay for the claim being sold. It is usually possible to negotiate a requirement that payment be made within some specified time period, *e.g.*, three business days from the execution of the purchase agreement.

**Does the Seller Get to Keep All of the Buyer's Payment?:** Claim buyers also manage risk by requiring claim sellers to refund – with interest – a portion of the purchase price paid by the buyer, if the claim the buyer bought is reduced or attacked in any way. The refund is proportionate to the amount of the claim reduced – *e.g.*, if the claim is cut in half, the seller must refund half the purchase price.

Typically, claim purchase agreements provide that a refund will be due, not only if the purchased claim is reduced, but also if it is objected to or otherwise challenged, even though the objection may later be resolved in the claim seller's favor. This means that the seller might have to refund money to the buyer, with interest, when an objection is filed, only to resolve the objection and receive some of that money back again (but without the interest). To address this problem, the seller may (a) ask that no refund be due until the court issues a final order reducing the claim or (b) ask for a "defense period," during which time the seller will attempt to resolve the objection and the buyer will not seek a refund.

**How Broad Are the Representations the Seller Must Make Regarding the Claim?:** The buyer typically asks the claimant-seller to promise that numerous assertions about the nature of the claim and the claimant's relations with the debtor are true. Because the seller's monetary
obligations to the buyer are triggered by breach of these representations, creditor-sellers should consider each proposed representation carefully to be sure it is accurate.

Buyers will almost always insist on a statement that the claim is (in typical language) a "valid, liquidated, and undisputed obligation of the debtor not subject to offset, reduction, or objection". However, be careful of representations like these:

– **No liens on the claims to be sold:** If the seller has a lender with a lien on accounts receivable, the bankruptcy claims may be subject to that lien; the buyer will want a lien release from the lender.

– **Seller does not owe the debtor money or have possession of any of the debtor's property:** If the debtor holds a claim that might be offset against what the debtor owes the claim seller (*e.g.*, a claim for a refund from the seller), or if the seller has custody of the debtor's property (*e.g.*, special tooling used in making product for the debtor), this representation must be conformed to reflect those facts.

– **Seller received no payments from the debtor during the 90 days before the commencement of the debtor's bankruptcy case:** The Bankruptcy Code's preference statute (11 U.S.C. §547) allows a debtor to recover certain amounts paid to creditors during the 90 days before the bankruptcy case was filed. A creditor's claim may be disallowed until the creditor repays such amounts. Buyers of claims want to know if this is a risk.

**How Broad Is the Seller's Obligation to Indemnify the Buyer for Its Losses, including Attorneys' Fees?** In addition to requiring refunds, purchase agreements also require the claim seller to indemnify the buyer for losses resulting from breach of the seller's representations.
Usually quite broad, these provisions can be read to require a seller to pay the buyer for any damages, however unforeseeable, that the buyer might sustain to its own business as a result of the disallowance of the purchased claim, as well as for any actions the buyer's attorneys might choose to take in the bankruptcy case, including basic tasks like reviewing objections and monitoring the proceedings.

Because the refund obligation places on the seller the financial risk of a claim's reduction, the seller, not the buyer, should determine whether to incur the costs of defending an objection to the claim. It may be possible to negotiate documents that give the seller the right to defend a claim free of any obligation to indemnify the buyer for duplicating that effort and that otherwise reasonably limit the seller's indemnification obligations, including by excluding damages that arise only indirectly from the reduction of the claim.

While it can be a quick way of cashing out of a bankruptcy case, selling claims is not without risks, some of which are not obvious. An insolvency professional with experience in claims trading can help you navigate the pitfalls in these transactions.
CASE NOTE

When the "Goo" Hits the Fan, the Debtor Can't Cap the Clean-Up Claim: Ninth Circuit Holds That Landlord's Claims for Tort Damages Are Not Capped by 11 U.S.C §502(b)(6)

Summary: In Saddleback Valley Community Church v. El Toro Materials Co., Inc. (In re El Toro Materials Co., Inc.), 504 F.3d 978 (9th Cir. 2007), petition for cert. filed, 76 U.S.L.W. 3417 (U.S. Jan. 30, 2008) (No. 07-1002), the Ninth Circuit Court of Appeals determined that the cap imposed by 11 U.S.C. §502(b)(6) ("Section 502(b)(6)") on a landlord's damages resulting from the termination of a lease of real property does not extend to "collateral damage" to the leased premises – in this case, the costs associated with the debtor's dumping thereon of 1,000,000 tons of "wet clay goo".

Background: After Debtor El Toro Materials Company, Inc. ("El Toro"), rejected its lease of nonresidential real property leased to it by Saddleback Valley Community Church (the "Landlord"), the Landlord brought an adversary proceeding claiming approximately $23 million in damages (the "Clean-Up Claim") arising from the dumping of one million tons of wet clay "goo" on the premises by El Toro.

Although the Landlord included a breach of contract claim in its complaint, it also asserted tort theories of recovery, including waste, nuisance, and trespass. El Toro asserted that the Landlord's Clean-Up Claim came within the cap on landlord damages imposed by Section 502(b)(6) and that, once the Landlord had been allowed a claim calculated pursuant to Section 502(b)(6), it could have an allowed claim for no other amounts.

The bankruptcy court agreed with the landlord, but, on appeal, the bankruptcy appellate panel ("BAP") reversed, agreeing with El Toro. The BAP apparently considered itself bound by its holding in In re McSheridan, 184 B.R. 91 (B.A.P. 9th Cir. 1995), which held that the Section 502(b)(6) cap subsumes damages arising from breach of any and all provisions of a lease, including lease covenants.

Holding: The Ninth Circuit panel reversed the BAP and upheld the bankruptcy court, finding that the Landlord was entitled to an uncapped Clean-Up Claim. The panel remanded for a determination of the merits of the Clean-Up Claim.

The panel held that El Toro's position was supported by neither the language nor the policy of Section 502(b)(6). As to the language, Section 502(b)(6) caps landlord's claims "resulting from the termination of a lease of real property". The Ninth Circuit proposed a straightforward test: "Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?" 504 F.3d at 981. The panel found that the Landlord would have had the same Clean-Up Claim, whether the lease had been assumed or rejected; put another way, the "goo" appeared, not as a result of the rejection of the lease, but as a result of the actions and/or inactions of El Toro at the site.
As to policy, the Ninth Circuit observed that including collateral damages under the cap would create a moral hazard, encouraging a tenant to inflict – negligently or otherwise – any amount of damage, without fear of liability beyond the cap. Put another way, if the lost rent under the rejected lease were sufficiently large to require imposition of the cap, the debtor-tenant could inflict collateral damage, essentially, for free. Moreover, the appellate court observed that El Toro's position would create another perverse incentive: to reject what might be an otherwise desirable lease in order to obtain the benefits of the purported cap on collateral damages to the premises.

Finally, the Ninth Circuit noted that the BAP had ruled differently in reliance on the BAP's McSheridan precedent. The panel therefore expressly overruled McSheridan, to the extent McSheridan held that Section 502(b)(6) limits "tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term". Id. at 981-82.

**Comment:** The holding in *El Toro* is, on its facts, unremarkable: the damages caused by the dumping of tons of waste upon a leased premises would not appear to result from the rejection or termination of the lease. However, it is not clear from the *El Toro* opinion how narrowly the Ninth Circuit might interpret the concept of "damages directly arising" from a tenant's rejecting a lease in the middle of its term.

It is also unclear to what extent *McSheridan* remains viable. The *El Toro* court appeared to find it significant that the Landlord's Clean-Up Claim was for, or could be phrased in terms of, tort damages. It also suggested that the cap was meant to apply only to claims for lost future rental income. *McSheridan* held that the cap applied to damages arising from any breach of contract by a rejecting debtor-lessee – not just claims for lost future rent, although it is with reference to such rent that the capped claim is measured – and did not speak in terms of tort damages. It may be that application of the cap in the future will sometimes depend upon how successful landlords and debtor-tenants are at characterizing a landlord's damages as sounding in contract (capped) or tort (not capped).

Finally, practitioners should watch for whether – and if so, how – other courts apply the Ninth Circuit's "collateral damage" doctrine to claims other than those arising from physical damage to the property itself.